# U.S. ECONOMIC RELATIONS WITH CANADA

## HEARING

BEFORE THE

## SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY

OF THE

## COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

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MARCH 10, 1982

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Printed for the use of the Committee on Foreign Relations

U.S. GOVERNMENT PRINTING OFFICE
94-165 O WASHINGTON : 1982

S381-29

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# U.S. ECONOMIC RELATIONS WITH CANADA

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**WEDNESDAY, MARCH 10, 1982**

UNITED STATES SENATE,
SUBCOMMITTEE ON INTERNATIONAL
ECONOMIC POLICY OF THE
COMMITTEE ON FOREIGN RELATIONS,
*Washington, D.C.*

The subcommittee met at 10:15 a.m., in room 4221, Dirksen Senate Office Building, Hon. Charles McC. Mathias (chairman of the subcommittee) presiding.

Present: Senator Mathias.

Senator MATHIAS. The committee will come to order.

First, I would like to welcome you to this hearing of the International Economic Policy Subcommittee. The purpose of the hearing is to be advised of the administration's views on the current state of economic relations between the United States and Canada, and merely asking the question does not imply that the committee has assumed that they are anything other than good or that the general relationship with Canada is other than good, but to make sure that they continue to be good, we thought a little examination was in order.

We are especially interested in hearing what the administration proposes to do in response to those aspects of Canada's investment and energy policies, which some people, at any rate, think could have a negative impact on the United States.

But I certainly would not want to leave the impression that the subcommittee is only interested in the troublesome aspects of United States-Canadian relations because, as I have indicated, there are a great many positive points as well and we would like to hear testimony on the positive side as well as the negative side.

The key point really is that economic relations between the United States and Canada are of immense importance to both countries and certainly have the potential of being of great mutual benefit and ought to be of mutual benefit.

Therefore, we share a responsibility to do what we can to improve these relations, to maintain them at the highest possible level; and simply to pass over in silence, to neglect problems that are of concern to either country, one or the other, or to sweep under the rug with generalities and platitudes those things that deserve some study is not in the long run a helpful attitude.

I think the best of friends owe each other honest opinions and full attention to the concerns that underlie those opinions, so we are very happy to have today the Honorable Robert Hormats, Assistant Secretary of State for Economic and Business Affairs, the Honorable Marc Leland, Assistant Secretary of the Treasury for International

Affairs, the Honorable Raymond Waldmann, Assistant Secretary of Commerce for International Economic Policy, and the Honorable Harvey Bale, Assistant Trade Representative for Investment Policy.

If there was ever a table of experts on this subject, we have it.

Mr. Hormats, will you begin this discussion? Let me say to all of you that your full statements will appear in the record and you are at liberty to summarize them if you choose to do so.

## STATEMENT OF HON. ROBERT D. HORMATS, ASSISTANT SECRETARY FOR ECONOMIC AND BUSINESS AFFAIRS, DEPARTMENT OF STATE

Mr. HORMATS. Thank you, Mr. Chairman.

First, I am delighted to have the opportunity to testify on a subject that my colleagues on this panel and I have spent many hours deliberating among ourselves and with the Canadians, in the spirit that you set out in your opening statement, the first one of ascribing the benefits of our overall relationship, and then one I think you have put very well, that the best of friends owe one another honest opinions.

Let me discuss both the mutual benefits and the problems in the Canadian-United States economic relationship.

First, as trade figures indicate, we have a thriving two-way trade which exceeded something on the order of $83 billion in 1981; there is a lot of mutual benefit in both manufactured areas of trade and raw materials, although there are as well some problems which emerge from time to time in the trading relationship.

Maine's recent problems with Canadian potatoes is indicative of problems that tend to crop up from time to time. On environmental issues there are some differences and some problems, but we have a cooperative process for resolving those, and basically we share the same objective of improving the environment.

Defense cooperation between the two countries is excellent. It is good that we rarely hear about it as an issue. The fact we don't hear about it, I think, indicates the wholesome nature of the cooperation we do have, both within NATO and bilaterally.

With respect to fisheries, there are a number of specific problems that we have from time to time, but I think we have agreed on a process for resolving those. The Alaskan pipeline is a particularly important project for both countries. Congress last year passed legislation submitted by the President to facilitate the private financing of the Alaska pipeline, and we are most eager that there be the necessary private financing to enable that pipeline to move forward.

There are, of course, particular problems that have come up. In the best of relationships, problems emerge, and I think it is fair to say that with respect to economic relations between the United States and Canada, we have had our share, particularly over the last year or year and a half when Canada has moved toward more nationalistic policies with respect to both trade and investment, particularly in the sector of energy.

In my testimony I have laid out some of the more detailed elements of Canada's national energy program which concern us. We have testified before, all of us, on the 25-percent back-in provision. We have had consultations with the Canadians on this issue, both here and in

Ottawa. I think all of our secretaries have discussed this with the Canadians. Secretary Regan made a trip to Canada in October and Ambassador Brock in January, and these issues were discussed; I had a meeting with the Canadians and also raised this issue.

We have gotten some ex gratia payments by the Canadians. These were a positive step but only a very small step, and not adequate to compensate for the value of what was taken.

The petroleum incentives program [PIP], is part of the new Energy Security Act which has just been proposed by the Canadian Government to the Canadian Parliament. It has had its first reading but it is still under consideration in the Canadian Parliament.

There are a number of problems with PIP because, first of all, the incentives that are paid to firms depends on the degree of Canadian ownership. Also, qualifying firms must meet strict control tests which verify that the enterprise is controlled and directed by Canadians; there are a number of specific problems which emerge from this.

The Canadian ownership rules concern us because they embody an overtly discriminatory regime based on nationality to award financial grants to explore in Canada. The control status test troubles us because of a large degree of subjective discretion rather than objective criteria for those firms. Plans have been modified to a degree, most recently on February 9, but there are a number of changes that are still unclear and there is still an enormous amount of uncertainty about this, so this is one element of the plan which does concern us.

Second, we are concerned by the constrained shares provision of the Energy Security Act, which gives Canadian corporations the means to achieve and maintain a certain level of Canadian ownership in order to qualify for the petroleum incentives grants. We have had initial discussions with the Canadians on this issue and voiced certain concerns.

For instance a two-thirds vote of holders of a class of shares can restrict eligibility for ownership of that class of shares. This provision is potentially discriminatory. It could depress prices of stock in foreign hands since Canadians could be excluded as potential shareholders. We intend to make our concerns clear to the Canadians in subsequent discussions.

There are other problems we have with the Committee on Megaprojects, Industrial and Regional Benefits, which has as its objective increased participation of Canadian firms in major projects. There are a number of concerns here with respect to requirements for the procurement of Canadian goods and services in the energy sector. Depending on how the program is administered, its operations may be in conflict with the provisions of, particularly, GATT [General Agreement on Tariffs and Trade], article III regarding national treatment of imported products.

Then there is the Canada Oil and Gas Lands Administration [COGLA], which has been established by the Canadian Oil and Gas Act to redistribute exploration rights already held by private companies. In my testimony I have gone into some of the detailed concerns we have about this. Depending on how this is administered, COGLA raises a number of potential concerns to us.

In addition, you are familiar with the concerns we have over the Foreign Investment Review Agency [FIRA], which also requires

certain undertakings from prospective investors before approving an investment proposal. These are legally enforceable agreements or performance requirements such as undertakings to require purchases in Canada, export commitments, import restrictions, requirements that specify levels of Canadian management, et cetera.

There are a number of concerns about this in that it has a trade distorting effect and it is harmful to American firms that want to compete for export sales in Canada against Canadian firms in that certain investors in Canada are pressed to favor Canadian firms over foreign firms, not just American firms.

The national minerals policy deserves a moment of explanation. Canada has put it out in a paper that was just recently issued by Canada's Minister of Mines. It is not at this point a policy but is a discussion paper. It raises a number of questions and we will want to discuss with the Canadians the evolution of this policy and how it will affect our interests.

It is still in the process of discussion in Canada, however, and I think we will have an opportunity to make our views known to the Canadians.

Just to be brief about the rest of the process, we have had a number of discussions with the Canadians in the OECD on the questions of national treatment. We have had consultations under article XXII of the GATT on several of the discriminatory aspects of FIRA, and if indeed we do not feel these are satisfactory, we are likely to move to article XXIII of the GATT, which does provide for binding resolutions of particular problems.

USTR has played a very active and effective role in putting our views forward in the GATT on these issues. We have had a whole series of bilateral consultations and discussions with the Canadians, both here and in Ottawa, and I think we have not achieved as much progress as we would like. In fact, we have achieved all too little progress in most areas.

I do think Canada has a better understanding of our concerns, and I think we also are aware of some of the domestic political pressures which have impelled Canada to take some of these more nationalistic actions which we believe to be harmful to the interests of American companies operating in Canada and for overall trade relations.

Let me conclude simply by saying that we are concerned about Canadian practices. We are concerned for a number of reasons. One, we are concerned because of the impact on American companies, both American companies investing in Canada and those who want to trade with Canada. Two, we are concerned because these tend to undermine the international norms, principles of national treatment and nondiscrimination, which we and, indeed, most other countries in the world have worked very hard to promote and to gain broad acccceptance for.

Canada is not alone in this respect. There are other countries who are doing things of a similar nature. But Canada is a country that we look to to set a higher standard than I believe is being set by certain Canadian policies, and also we are concerned about the impact on other countries, because Canada is a country which is looked to to set a higher standard.

There are other countries which I believe may well decide that they

can get away with a certain additional amount of intervention in investment and trade decisions if they see some of the other larger countries, which should be good examples, taking the action that Canada has taken.

Now, how do we proceed? First, there are several things that we are doing and contemplate doing. One, it is essential that we continue and intensify bilateral consultations and pressure on Canada. Implementing regulations for the NEP [national energy program] are not all in place today.

Some new governmental agencies with potentially wide-ranging mandates have been created in the energy area and the scope of these operations is just now being developed. By staying in close touch with Ottawa, we will be better able to gage the impact of the NEP on U.S. investors as it evolves and to press for changes on those aspects which have an unfair or harmful impact.

Second, we should vigorously pursue our GATT case on FIRA, and initiate a case against the NEP if it is implemented in ways which are contrary to Canada's GATT obligations. This is important not only to seek redress for our specific problems with FIRA and the NEP, but also to enlist the support of others and test the ability of the current GATT framework to deal with trade-related investment issues.

Third, we need to continue to encourage Canada to live up to its OECD commitments on national treatment. The OECD investment instruments are not binding in the sense that they contain enforcement procedures or sanctions, but Canada as much as the other OECD countries has benefited from the kind of open international investment regime that the OECD is seeking to foster.

Canadians need to recognize the potentially harmful effects of their policies both within and outside the OECD. In this regard we expect the Canadians to notify to the OECD all NEP-related national treatment exceptions as they have agreed to do and to move to conform to a greater degree with the OECD's standards.

Fourth, we will continue to stay in close touch with United States investors in Canada in order to obtain their views of Canadian actions and legislation, to monitor the impact of the NEP as it develops, and to be aware of changes in the operations of FIRA. This is particularly important in view of the administrative discretion for Canadian officials provided for under both NEP and FIRA regulations.

Fifth, we are prepared to intercede with the Canadian authorities when we believe it necessary, when requested to do so by United States firms on specific problems which arise under either the NEP or FIRA. When there are instances of harmful or discriminatory treatment based on nationality of an enterprise, we will respond promptly and strongly.

Let me just conclude, Mr. Chairman, by saying that this is a most important issue. It is an issue which all of us have been involved in. We have expressed concerns to the Canadians on a number of these issues. We are concerned, as I say, about the impact on our companies, on our trade relations, on international norms and on the practices of other countries which could take this as a bad example.

Our hope is that Canada itself will recognize that these practices are not conducive to achieving some of the longer term development objectives which Canada seeks for itself. Now, it is not our business to

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tell Canada how to run its economy, far from it, but I think we have an interest in the success of Canada and their economic prosperity, their energy production, and I think some of these practices in that respect concern us as well.

So we intend to follow the course which I have described here in working with the Canadians, and working with our firms in insisting that the rights of our firms and principles of international norms and law be adhered to by the Canadians.

Thank you, Mr. Chairman.

[Mr. Hormat's prepared statement follows:]

PREPARED STATEMENT OF HON. ROBERT D. HORMATS

It is my pleasure to be here today to discuss the current state of United States-Canadian economic relations. This comprises a broad group of issues to which we give regular and high-level attention.

The United States-Canadian Interparliamentary Group, involving many of your colleagues, convened last week in Florida and addressed most, if not all, the issues I plan to raise here.

There are few countries so interdependent economically as the United States and Canada. Let me start, therefore, by putting issues between us in a broad perspective which reflects the depth, and the mutual benefit, of our relationship. With this as background, I will then discuss the economic differences between our two nations which have increased in the last year or so.

*Trade*

In 1981, two-way trade exceeded US$83 billion, accounting for over 17 percent of U.S. total foreign trade and more than 60 percent of Canada's total international trade. More than one-sixth of U.S. exports go to Canada, nearly twice that which go to Japan, our next largest customer. Canada sends us a number of important products—including not only raw materials such as minerals and wood products, but also an increasingly wide range of manufactured goods. The U.S./Canadian auto pact, which was the framework for a total exchange of automotive products in 1980 of $19 billion, has produced significant benefits for the United States and Canadian auto industry.

While United States-Canadian trade remains vitally important and beneficial to both sides, we have problems in specific fields. For example, Maine's problems with Canadian potatoes from the eastern provinces. These problems arise and can disturb our trade relations; but for the most part, they do not become major issues and are resolved in ways satisfactory to parties on both sides of the border.

*Environmental issues*

Canada and the United States share concerns about the preservation of our environment; both countries recognize that we must work together to achieve this goal.

The massive program to clean up the Great Lakes, begun a decade ago, continues. With the assistance of the International Joint Commission, the United States and Canada have succeeded in reversing a pattern of deterioration in the lakes which could have led to their biological death. The results of this massive effort are already evident.

Similarly, we recognize that we can deal with transboundary aid pollution, our principal environmental concern, only by working together. Five United States-Canada work groups were established over a year ago to define the dimensions of this problem and to assemble scientific data. Negotiations on a United States-Canada agreement on transboundary air pollution were opened last year. Canadian concerns will be very much in the minds of American policymakers during the renewal of the Clean Air Act. When we consider the work that lies ahead on air pollution, we must remember that the road to improved water quality in the Great Lakes was long.

*Defense*

In defense, we are the closest of allies. The defense of this continent must be shared if it is to be effective, and it is being shared. The principal bilateral defense tie, the North American Aerospace Defense Agreement, goes beyond our

joint undertakings within NATO. Policies are coordinated regularly in the Permanent Joint Board on Defense. Canadian and American forces as well as civilian personnel work and train together at bases in both countries. Cooperation in defense procurement benefits both economies.

*Fisheries*

Fisheries issues have been particularly important in recent years. In 1979, the United States and Canada signed fisheries and boundary agreements concerning the Gulf of Maine. Convinced that the fisheries agreement could not receive the approval of the Senate, the President withdrew it, just prior to his trip to Ottawa last March. Canada and the United States have now ratified the boundary treaty, and it is in effect. As provided for in that treaty, the World Court has established an Ad Hoc Chamber to determine the boundary. The Court's findings will be binding on both parties.

In the West Coast fishery, careful negotiation and a cooperative approach by both sides permitted the resolution—in 1981—of significant differences. In 1979 Canada had seized U.S. albacore tuna boats, and the United States had embargoed tuna imports from Canada. In a treaty which both countries ratified last July, Canadian and U.S. vessels are permitted to fish for albacore tuna along each other's coasts and to land their catches at designed ports in the other country.

*Alaskan gas pipeline*

A joint project of the greatest importance to both our countries passed an important stage late last year when, on December 10, the Congress passed legislation submitted by the President to facilitate the private financing of the Alaska Gas Pipeline. This prodigious undertaking would afford the lower 48 states access to 12 percent of America's natural gas reserves and provide the equivalent of 400,000 barrels of oil per day, for at least 20 years. It will stimulate exploration which could lead to major new finds. Canada and the United States already have moved ahead on the construction of the southern portions of the pipeline—linking Alberta to the U.S. West and Midwest Markets.

Cooperation such as this has been customary in United States-Canadian economic relations. Canada has benefited greatly from the openness of the U.S. economy, and from major resources provided by U.S. investors. U.S. exporters and investors have benefited from the Canadian market. The prosperity of both countries has been enhanced by extensive trade, flows of energy resources, and flows of capital. Canadian economic policy has undergone some important changes, however, and these are a source of much of the current friction. Before I describe those changes, I would like to clearly state our policy in one key area.

*U.S. investment policy*

United States' investment policy has, for many years, been based on the fundamental premise that an open international investment system provides the most efficient allocation of global resources. When capital is free to move without hindrance, many nations can benefit through expanding world output. As a corollary, U.S. Government policy is to minimize intervention in the private sector decision-making process.

Two basic tenets, which we have strongly supported, are the national treatment and most-favored-nation principles. And we insist, of course, that investment be treated in a fashion consistent with international law. The national treatment principle holds that foreign investors should be treated no less favorably than domestic investors in like situations. The most-favored-nation principle holds that the investors of one foreign country should be treated no less favorably than the investors of any other foreign country. The two principles have the common characteristics of reducing instances of discrimination directed at foreign investment. We have worked bilaterally and multilaterally to gain wide acceptance of these principles and to extend the application of such treatment to a wider range of enterprises.

A particularly important step in this process took place in 1976 when the United States joined other OECD member governments in participating in the consensus adopting a Declaration on International Investment and Related Decision on national treatment. The Declaration and Decision were reviewed and reaffirmed in 1979 by a consensus of OECD countries in which the United States also participated.

The adoption of restrictive investment and trade policies by our neighbor and largest trading partner is a matter of particular concern which poses fundamental issues for the members of the OECD, particularly the United States.

Our concerns center on two areas, the restrictive and discriminatory policies in the National Energy Program (NEP), now being established and the activities of the existing Foreign Investment Review Agency (FIRA). In addition, Canada just announced a new set of mineral policy proposals which I will mention briefly.

*National Energy Program (NEP)*

Canada proposed its National Energy Program, or NEP, in October 1980. The basic policy is to be implemented by two major pieces of legislation, the Canada Oil and Gas Act, ("Bill C–48") and the Energy Security Act, or ESA. The Canada Oil and Gas Act passed the Parliament in December. The ESA has just been introduced in the Parliament.

Our key concern about the NEP is not its objective—the well publicized "Canadianization"—but the means used to achieve the objective, especially what we believe to be discriminatory and unfair treatment of foreign investors. The elements of the program which are of most concern are:

The 25 percent crown share, or "Back-in," in existing oil and gas discoveries in Federal, or "Canada," lands. This changes the rules of the game for foreign firms which have already invested in exploration and development of Canadian energy resources. The Canadian Government now plans to pay a portion of the exploration costs incurred by the companies in Canada lands (which include the Northern Territories and offshore areas), calling these "ex gratia" payments. We believe the decision to make these payments was a positive step. But it is only a very small step; and it is not adequate to compensate for the value of what was taken.

The old system of depletion allowances available to all producing firms has been replaced by the Petroleum Incentives Program (PIP). Under the PIP, the level of Canadian ownership determines the amount of exploration grants awarded to a company—with the maximum grants awarded to companies with Canadian ownership of 65 percent or higher. Moreover, qualifying firms must meet strict control tests which verify that the enterprise is controlled and directed by Canadians. The Canadian ownership rate rules concern us because they embody an overtly discriminatory regime based on nationality to award financial grants to explore in Canada. The control status test troubles us because of the large degree of subjective discretion—rather than objective criteria—that confronts firms. The plans for the Petroleum Incentives Program have been modified twice since their initial appearance, most recently on February 9. These changes were intended to clarify the calculation of the ownership rate and to lessen the record-keeping burden on smaller companies. However, the firms are still uncertain as to where they stand because the depletion allowance system has been cancelled but companies still are awaiting final regulations governing the PIP.

We are also concerned by the constrained shares provision of the ESA, which gives Canadian corporations the means to achieve and maintain a certain level of Canadian ownership in order to qualify for the petroleum incentives grants. We have had initial discussions with the Canadians on this issue, and voiced certain concerns. For instance, a two-thirds vote of holders of a class of shares can restrict eligibility for ownership of that class of shares. This provision is potentially discriminatory; it could depress prices of stock in foreign hands since non-Canadians could be excluded as potential shareholders. We intend to make our concerns clear to the Canadians.

The Committee on Megaprojects Industrial and Regional Benefits, or CMIRB, has as its objective to increase the participation of Canadian firms in major projects and to increase procurement of Canadian goods and services in the energy sector. Depending on how the program is administered, its operations may be in conflict with the provisions of the General Agreement on Tariffs and Trade (GATT), particularly Article III, regarding national treatment for imported products.

Production licenses for oil and gas on Canada lands will only be available to companies with 50 percent or greater Canadian ownership. Thus, U.S. companies which have explored on Canada lands, and made an exploitable discovery, would be forced to join with a Canadian partner holding at least 50 percent interest, before receiving a license to produce.

The Canada Oil and Gas Lands Administration (COGLA) has just been established by the Canada Oil and Gas Act to redistribute exploration rights

already held by private companies. We are seeking more information on this. On the basis of what we know, we have a number of initial concerns. By requiring the owners of existing exploration interests to negotiate new exploration agreements with the Government of Canada or to apply for provisional leases, the COGLA will have significant discretion in controlling ongoing exploration operations. The actual guidelines for the organization are still being drawn up. We have learned that firms may be asked to relinquish a large share of their exploration acreage as a condition for receiving a new exploration agreement (although in cases where leases had already expired, new conditions may have been anticipated). The stated purpose is "to meet an objective of substantially increasing crown reserves (and) to provide for new entry into the frontier areas." We will make it clear that this should not become another retroactive measure. COGLA is also supposed to increase Canadian industrial, employment, and social benefits from oil and gas activities on Canada lands. (It is not clear how this agency will combine with the CMIRB to enforce "Buy Canadian" policies on energy enterprises.) The COGLA also seeks to help meet "Canadian government objectives of increasing equity participation by Canadians and Canadian companies" and to achieve "the objective of increased government participation." Depending on how it is administered, COGLA raises many potential concerns.

*Foreign Investment Review Agency (FIRA)*

I would now like to turn to the Foreign Investment Review Agency, or FIRA, and describe those elements which concern us most.

The FIRA is a legislatively-mandated screening agency which must approve incoming investments. We have not challenged FIRA's existence or its basic promise—to review inward investment—although we have stressed, and Canada itself has acknowledged, that it is an exception to the national treatment principle (Canada has notified this to the OECD). Our problems center on FIRA's operations.

First, in judging an application by a foreign investor, FIRA applies a vague and highly subjective standard: whether there is significant benefit to Canada. Second, FIRA in many cases extracts undertakings from prospective investors before approving an investment proposal. These are legally enforceable agreements, or performance requirements, such as undertakings requiring purchase in Canada, export commitments, import restrictions, requirements to hire specified levels of Canadian management and labor, obligations to move productive facilities from the United States to Canada, obligations to transfer patents and know-how to Canada without charge, and other commitments which run counter to generally accepted international practices. These measures can seriously distort investment and trade flows between the United States and Canada. Moreover, because of the way FIRA now operates, its very existence undoubtedly discourages many would-be investors.

The FIRA is essentially aimed at new investment. But it also reviews changes in ownership of Canadian subsidiaries of foreign firms. This might occur when two American firms merge or when an American firm wishes to sell its Canadian subsidiary to another non-Canadian firm. These transfers are frequently disapproved by FIRA, even in situations where there is no change in the level of Canadian ownership. This FIRA policy can have the effect of depressing the value of U.S. firms' assets in Canada.

Despite Canadian Government claims of a high rate of approval by the FIRA, its statistics present an incomplete picture. Many foreign investment applications are either never presented, withdrawn before disapproval, or are greatly modified to accommodate FIRA-mandated performance requirements.

*National minerals policy*

Canada announced on March 8 a set of new minerals policy proposals. These were the subject of a joint Federal-Provincial Ministers meeting in mid-January. Though we have made only a very preliminary review of the proposals, I should note that the level of foreign ownership in the Canadian minerals sector is about 36 percent, considerably lower than in the energy sector. The new proposals refer to maintenance of "stability" in taxation and the investment climate and do not appear to contain specific reference to a Canadianization goal like that in the NEP. We have also noted that there is a reference to increasing procurement of mining machinery from Canadian sources. It is not clear precisely how this would be implemented; we will need to monitor this aspect.

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*U.S. response to the Canadian investment policies*

The rising concern in the United States regarding discriminatory Canadian investment and energy policies has engendered wide ranging and vigorous discussion on how we should respond. The concerns over Canadian investment policies expressed here in Congress, and by U.S. business and labor groups, are valid and we share them.

*NEP—Bilateral*

We have met with Canadian officials on a bilateral basis on numerous occasions to enumerate—with the frankness characteristic of our countries' relationship—our concerns on the NEP. The President, Secretary Haig, Secretary Regan, Ambassador Brock, and other Cabinet officers, and other senior officials have been actively involved in this dialogue. Secretary Haig has had several meetings and conversations with External Affairs Secretary MacGuigan. Secretary Regan headed a small delegation to Ottawa last October to discuss investment and energy policies. More recently, on December 16, I led an interagency delegation to Ottawa and we presented our case against the "back-in" provision. Ambassador Brock visited Canada in late January for further discussion, including a meeting with Prime Minister Trudeau.

We concentrated our talks initially on the NEP provisions, such as the back-in, contained in the Canada Oil and Gas Act. The Canadian Parliament passed this legislation on December 18. During the course of our discussions, lasting more than 1 year, the Canadians decided to make "ex gratia" payments for the crown share. But these payments cannot be regarded as adequate, and there have not been any significant modifications in other elements of the legislation of concern for foreign investors.

The Energy Security Act (ESA) contains other objectionable provisions, such as the Petroleum Incentives Program (PIP), which I mentioned earlier. That legislation was formally introduced in Parliament about 2 weeks ago. A Canadian team visited Washington on March 1 to brief U.S. officials on this legislation. The ESA introduces a number of complex changes to Canadian energy policy, and we have raised a number of important concerns about it. We are studying the effects of the ESA on U.S. interests and will have further discussions with the Canadian Government on the issues raised by ESA.

*NEP—multilateral discussions and concerns*

In addition to bilateral contacts, we have had numerous consultations on the NEP in multilateral fora, in the OECD Committee on International Investment and Multinational Enterprises (CIME) and the International Energy Agency.

In the CIME, several other member countries have joined us in criticizing the discriminatory aspects of the NEP which depart from national treatment. We first presented our concerns in the March 1981 meeting of the CIME under the consultations provisions of the 1976 investment instruments. (This was the first formal use of these provisions.) The discussions continued in subsequent meetings of the Committee and its Working Group on International Investment Policies. The United States and the other countries not only raised the specific, substantive aspects of the NEP which depart from the national treatment principle, but also noted that Canada's discriminatory policies could disrupt efforts within the OECD aimed at expanding and strengthening the national treatment principle and could undermine acceptance of the principle by the developing countries.

In response, the Canadian Government described the NEP to the CIME members and reaffirmed its commitment to the national treatment principle. The Canadian Government promised to notify to the OECD the elements of the NEP which are national treatment exceptions. On the other hand, Ottawa has not, in our view, adequately reconciled its current energy policies with its OECD commitments. Also, the Canadian Government has not, to date, fully responded to the various specific concerns raised by the other OECD countries during the consultative process. Thus, the results of these consultations have not been fully satisfactory. However, they have been a useful indication to Canada that the NEP is not solely a U.S. concern, but one which is widely shared among OECD member countries.

In the IEA, the effects of the NEP pricing, taxation, and production policies on Canadian energy supplies have been the subject of multilateral discussions. We have raised questions about the potential negative supply consequences of the

NEP on Canada's ability to meet its IEA undertakings. These include placing maximum reliance, as practicable, on market forces to promote production and conservation.

A positive development was the statement in the Canadian budget message of November 12 that "the special measures being employed to achieve more Canadian ownership and control of the oil and gas industry are not, in the Government of Canada's view, appropriate for other sectors." On the basis of this assurance, we expect that the Canadian Government will not extend NEP-type discriminatory measures. Such measures would introduce disturbing new shocks in our bilateral economic relations.

*FIRA*

As with the NEP, we have had extensive consultations with the Canadian Government on FIRA's practices and its impact on U.S. investors. The Canadian Government is keenly aware of our views, but to date has shown little willingness to make any significant modifications to meet our specific concerns. Therefore, we reluctantly concluded that we must take our case to the GATT for those elements of FIRA's policies which we consider to be GATT violations.

GATT Article XXII provides for consultation between Contracting Parties on any matter covered by the GATT. At our initiative, consultations under this Article took place in Geneva on February 17. Observers from the European Community delegation were also in attendance. At this meeting, we argued that the export and local contents requirements imposed by FIRA in the investment approval process are contrary to GATT articles regarding (1) quantitative or other restrictions on imports, (2) national treatment and (3) import substitution. The Canadian side heard our case but asked for an adjournment so they could seek instructions from Ottawa on their response.

If the results of these consultations are not satisfactory, we would likely seek a GAT Article XXIII proceeding. This is a more formal process, consisting of an international panel. The decision is binding. In that proceeding, we would base our case on the points described above, but would also argue that FIRA's practices nullify the benefits of earlier trade agreements and concessions.

The November Canadian budget message promised a review of FIRA's administration and deferred, at least for the present, an earlier proposal to expand FIRA's mandate to review and monitor already-established foreign investments in Canada. This is certainly a positive development. An expansion of FIRA's mandate would have been a serious new derogation from international norms. We were told in the fall that the FIRA was considering adopting a policy of more explicitness and openness in its decisionmaking process—in particular, publicly explaining the reasons for disapprovals. There were also indications that size criteria would be applied, granting small businesses special treatment. While certain of our important concerns would remain, these would be positive steps. We have not, however, seen actual signs of such new policies. Foreign investors continue to face complex and difficult FIRA performance requirements.

We have an ongoing effort to obtain information on individual companies' experiences with FIRA. This is needed as a basis for presenting our views on FIRA's effects to Ottawa and to international organizations which oversee investment matters. We, of course, avoid jeopardizing individual companies' relations with the Canadian Government. Thus it is sometimes difficult to obtain a complete picture through the fact-finding process.

*Other issues*

In a related area, one of my deputies, Matt Scocozza, visited Ottawa last week to hear Canadian views on the access of U.S. trucking companies to the Canadian market. We are seeking to determine the effect of Canadian Provincial regulations and the FIRA on U.S. trucking firms. In the United States, Canadian firms have benefited equally with U.S. firms from the recent liberalization of U.S. laws. The ICC has halted action on applications by Canadian trucking firms to operate in the United States, at least until it can investigate the issues.

At the discussions last week, involving several U.S. agencies and Canadian Provincial and Federal officials, we gathered information regarding the relationship of the Provincial and Federal authorities about U.S. truckers' access to the Canadian market. This information indicated that provincial regulation did not appear to be unfair to American trucking. The ICC will consider this information in their investigation, and we will maintain our active involvement in the issues.

Finally, because the National Minerals Policy proposals have just been announced, we have not had an opportunity to assess their implications for U.S. interests, but they appear to raise a number of new issues. We will probably need to seek consultations with the Canadian Government. If these proposals are adopted in ways which are detrimental to U.S. interests, we will take whatever steps are appropriate.

*Mineral Lands Leasing Act*

The NEP and FIRA raised questions about whether Canada should still be considered a "reciprocal country" under the terms of the Mineral Lands Leasing Act of 1920, thus permitting continued access to U.S. Federal mineral lands to companies owned wholly or in part by Canadians. In February, after a public comment period and after soliciting the views of other interested agencies, Interior Secretary Watt ruled that Canada's status as a "reciprocal" country under the terms of the Mineral Lands Leasing Act should not be changed. Interior took into account public comments on factual questions to aid in interpreting whether the MLLA's provisions were met. Interior based its decision on a two-part test: (1) whether U.S. citizens are precluded by Canada from investing in Canadian corporations and (2) whether U.S. investors are discriminated against by exclusion from access to Canadian mineral resources. The Interior Department determined that U.S. citizens may make such investments and that they have access to Canadian mineral resources. It is worth emphasizing that this determination was made in the narrow context of complying with a specific U.S. law, and does not address, or prejudice, our position on broader Canadian investment and energy policies.

*Future U.S. responses*

As a result of the extensive discussions we have had with Ottawa, I think that it is fair to say that the Canadian Government has a heightened awareness of U.S. congressional, executive branch, and public concerns about the discriminatory and unfair elements of the NEP and FIRA. For our part, we understand somewhat better—although we continue to have major problems with—the Canadian rationale for these programs. And we have a much better knowledge of the administrative details of these policies and how they may affect U.S. investors in Canada.

At the same time, substantial differences remain between the United States and Canada over the efficacy and fairness of these Canadian investment and energy policies and their potential impact on the international norms to which most developed nations adhere, as well as the impact on our bilateral economic relationship. Because the NEP is still evolving, and because the laws and regulations regarding both NEP and FIRA allow for a large measure of administrative discretion in implementation, we cannot accurately forecast the full impact yet. I would now like to describe some of the potential future actions which are available to us on these issues.

First, I think it is essential that we continue and intensify bilateral pressure. The implementing regulations and administrative procedures for the NEP are not all in place. Some new governmental agencies with potentially wide-ranging mandates have been created in the Canadian energy area, and the scope of operations of these agencies is just being developed. By staying in close touch with Ottawa, we will be better able to gauge the impact of the NEP on U.S. investors as it evolves and to press for changes in those aspects which have an unfair or harmful impact.

Second, we should vigorously pursue our GATT case on FIRA and initiate a case against the NEP if it is implemented in ways which are contrary to Canada's GATT obligations. This is important, not only to seek redress for our specific problems with FIRA and the NEP, but also to enlist the support of others and test the ability of the current GATT framework to deal with trade-related investment issues.

Third, we need to continue to encourage Canada to live up to its OECD commitments on national treatment. The OECD investment instruments are not binding in the sense that they contain enforcement procedures or sanctions. But Canada as much as the other OECD countries has benefited from the kind of open international investment regime that the OECD is seeking to foster. The Canadians need to recognize the potentially harmful effects of their policies both within and outside the OECD. In this regard, we expect the Canadians to notify to the OECD all NEP-related national treatment exceptions, as they have agreed to do, and to move to conform to a greater degree with OECD standards.

Fourth, we will continue to stay in close touch with U.S. investors in Canada in order to obtain their views of Canadian actions and legislation, to monitor the impact of the NEP as it develops, and to be aware of changes in the operations of FIRA. This is particularly important in view of the administrative discretion for Canadian officials provided for under both NEP and FIRA regulations.

Fifth, we are prepared to intercede with the Canadian authorities when we believe it necessary or when requested to do so by U.S. firms on specific problems which arise under either the NEP or FIRA. When there are instances of harmful or discriminatory treatment based on nationality of an enterprise, we will respond promptly and strongly.

*Conclusion*

In dealing with these investment, energy, and minerals concerns, both Canada and the United States need to keep in mind the importance of resolving our problems in ways consistent with our broader relationship. And we also need to recognize these problems as part of a troubling international progression of investment restrictions. To counter this trend, the United States has sought international discussion of a number of investments issues—notably national treatment and the imposition of performance requirements similar to those mandated by FIRA—in a number of organizations, including the World Bank, the GATT, and the OECD. In the Executive Committee of the OECD in January, for example, we gained the agreement of other members to reinvigorate the OECD's work on investment. In our preparations thus far for the Versailles Summit and the fall GATT Ministerial meeting, we are encouraging other governments to consider a more rigorous international approach to investment problems.

Just as we expect that, over time, the deleterious effects of the NEP and FIRA will become clear to Canada, so do we hope that the positive value of international understandings to reduce or eliminate unfair or harmful investment policies will also become clear. In a period of rapid change and uncertainty, our mutual interests are best served by national policies which attempt to remove distortions to trade and investment flows and which have the effect of strengthening global allocation of resources according to economic criteria.

Senator MATHIAS. Thank you, Mr. Hormats.

I want to reserve questions for the panel at large, so I don't want to propound any questions to you. But just one point of clarification before we go to Mr. Leland.

This general policy of the Canadians, and particularly the energy policy, is not something which has sprung full-blown from the mind of Zeus all in one moment. In fact, I can recall discussing the energy question with Prime Minister Trudeau in the fall of 1974, I believe. So perhaps it would be helpful if you could give us just an idea of the chronology of this developing policy.

Mr. HORMATS. There is, as you say, a long history, particularly in the energy area. I do not have on the tip of my tongue all the details, but I think it goes back either to the latter part of the sixties or the early part of the seventies, when Canadian energy legislation did provide for a number of measures which would assure a certain measure of Canadian ownership of energy lands or crown lands.

Senator MATHIAS. Which was explained by the Prime Minister in the conversation to which I referred as being directed at providing an adequate reserve of energy for Canadian domestic use, and that that was really the primary goal of the policy as of that time.

Now, it seems to me from your description of it that it has evolved considerably from that rather conservative and prudent goal that was discussed in 1974.

Mr. HORMATS. I think it has. I think the principles of Canadianization were set down in earlier legislation in some provisions for giving the Government a share and Canadian firms a share of crown lands which is now called Canada lands. But we can give you a more detailed evolution of this.

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Essentially what has happened is the legislation we are dealing with today, the Energy Security Act and C–48, take us several steps beyond where it was by indicating, (1) particular levels of Canadian ownership required for production on Canada lands and (2) back-in provisions which did not exist before.

The PIP is something that is quite new and a major departure from the depletion allowances which previously prevailed for foreign and domestic firms. The PIP is now, as I have indicated, a set of incentives based on the level of Canadian ownership. So I think that these acts, this piece of legislation, has taken the thing well beyond where it was and injects some mandatory character and a degree of specificity that was not implied in legislation earlier.

In some cases these may be considered an evolution of earlier legislation. In other cases they are marked departures from earlier practices. We can get you a very detailed background sheet on how the policy evolves because there is a long history to the evolution of the policy.

Senator MATHIAS. I think that might be a helpful supplement to the record.

[The material referred to follows:]

THE EVOLUTION OF CANADIAN ENERGY POLICY

[SUBMITTED BY THE DEPARTMENT OF STATE]

Much of current Canadian energy policy, and particularly its energy self-sufficiency and Canadianization goals, traces its roots to two central factors: the evolving international energy environment of the early 1970's and the long-held belief by many in Canada that foreign interests controlled a larger share of Canada's economy than was prudent for Canada's economic well-being, especially in the energy sector.

The international energy scene prior to late 1973 was characterized largely by stable, low crude oil prices, relative supply abundance to meet then-existing demand, and little awareness on the part of Western government policymakers of the inherent security danger that increased reliance on foreign energy suppliers posed to their economies. As in the United States, Canada was rapidly exploiting its hydrocarbon resources, principally Alberta crude oil, exporting much of it to Western and Midwestern U.S. markets. By 1973, some 1.1 million b/d of Canada's 1.9 million b/d daily production went south of the border while eastern Canada, in turn, imported approximately 900,000 b/d from mostly Middle Eastern sources to meet its domestic needs.

The oil embargo in September, 1973 profoundly altered Western countries' attitudes about energy security and the vulnerability that growing energy dependence represented. In Canada, the National Energy Board published its National Oil Policy Statement in December, 1973 which, for the first time, established a crude oil export charge, export controls on petroleum products, and introduced a number of other conservation and export restriction measures. In early 1974, the Federal Government formally determined that Canadian oil supplies were not sufficient to serve both Canadian and export markets (largely to the United States) and instituted an oil export phase-out program.

Ottawa's interest in promoting Canadianization of the energy sector also got much of its impetus during this same period. In April 1974, Ottawa introduced the Foreign Investment Review Act which gave the government for the first time the authority and organizational mechanism to examine and disapprove new takeovers by foreign firms of Canadian firms or expansions by non-Canadian firms into new areas of business.

In 1975, Petro-Canada was created to act as the Government's instrument for direct energy sector participation. Canada's dependence upon largely foreign-owned oil companies for information on oil and gas reserves and production had become intolerable to many in Canada. Petro-Canada was to serve as Ottawa's "window" on the industry to ensure that Ottawa was actively involved in the crit-

ical energy development and planning decisions necessary for Canadian energy security.

In 1976, Ottawa developed further its program to reduce energy reliance on others and increase Canadianization. It adopted its Energy Strategy for Canada which was designed to achieve Canadian "self-reliance' in energy, whereby Canada's net imports would not exceed one-third of the country's total oil demand. Moreover, it specifically singled out the petroleum sector as a key target for increased Canadian ownership. The Strategy's other principal goals included: "appropriate" energy pricing, energy conservation, increased exploration and development, increased resource information, substitution of domestic energy for more expensive imported energy, new or improved transportation and transmission systems, improved emergency preparedness and increased research and development. This Strategy provided the general guidelines for Canadian energy policy until the introduction of the National Energy Program (NEP) in October 1980.

The evolution of Canadian leasing policy for energy exploration and development reflected this overall energy policy direction. Prior to 1970, operators of exploration leases were required to remit to the Canadian Government one-half their acreage under permit upon conversion of an exploration lease to a production lease. Moreover, operators were permitted some discretion in selecting the parcels of land to be remitted, and according to the Canadian Government, approximately 30 percent of the productive areas were, in practice, surrendered.

In 1977, leasing regulations were amended to authorize the government oil company Petro-Canada to take up to a 25 percent working interest in parcels of land upon expiration of a given exploration permit on federally-administered Canada Lands if no significant discovery had been made. (It was in this fashion that Petro-Canada assumed its current 25 percent interest in what later proved to be Canada's giant offshore hydrocarbon discovery, Hibernia,) Companies could avoid this action by applying at that time for a production lease rather than a permit renewal, subject to the above-described land remittances. This leasing regime remained in effect until the NEP was introduced in late 1980.

The combination of this evolving energy policy of the mid-1970's, coupled with the creation of the Foreign Investment Review Agency (FIRA) and Petro-Canada put the industry on notice that Ottawa would be taking an active role itself, and expected a greater energy role for all Canadians in the years to come. Thus, foreign ownership of Canada's energy sector declined between 1973 and 1979 from 78.7 to 72 percent as a result of government persuasion and a recognition by many energy firms active in Canada that greater Canadian participation would ultimately be in their own interest. Ottawa's policies were having the intended effect, and without inequitable treatment of Canada's foreign investors.

Unlike the Government of Canada's earlier energy strategies, the NEP announced in October 1980 represents a significant departure from the previous means the Government chose to pursue these energy self-reliance and Canadianization goals. For the first time, discriminatory treatment of foreign (largely United States) investors has become the official Canadian Government policy, the centerpiece of its Canadianization program. For the first time, the Government of Canada's desire to expand its direct role in the industry has been translated into provisions which force all companies to relinquish 25 percent working interest in their exploration and development undertakings without adequate compensation. For the first time, production on Canada Lands will only be granted to 50 percent Canadian-owned firms, even if the exploration expenses and risk were borne entirely by foreign investors. From the standpoint of the United States, these new measures represent a marked change from the way our two countries have conducted business and are no longer in keeping with Canada's international undertakings.

## STATEMENT OF HON. MARC E. LELAND, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. LELAND. I am happy to appear before your subcommittee to discuss the United States-Canadian economic relations. I have submitted a statement for the record, so I will just make a few comments.

I think Mr. Hormats has very well covered a lot of the areas that are of concern to us about Canada. I think your question is a very pertinent one. It is something that started out to be a perfectly noble, understandable objective.

Senator MATHIAS. It is something we wished we might have done 40 years ago.

Mr. LEVAND. That is right, when they were concerned about their energy security and that they would have the proper control over it. Even the mere fact of Canadianization, if you want to use that term, is their own business, but it has evolved, and while I don't have the chronology at my fingertips, I have found it interesting to look at files on United States-Canadian relations. I have gone back to 1972 and 1973, and papers prepared in 1981 look just like the ones written in 1972 and 1973 in many cases.

The only difference now is that we have taken a position, particularly by taking Canada to the GATT, because they really follow practices that cannot be tolerated. It is still a matter among friends, but they are following policies that started out to be somewhat noble and have now been extended way beyond that.

This does not include just NEP itself but also includes the provisions of FIRA. I think this is one of our major concerns, in addition to the fact that, as Bob said, what really is true is that the Canadians are following a policy that is detrimental to them as well as to us. It is our belief that it is a policy that is probably more detrimental to them than it is to us.

They are deterring foreign investment, while really they have come as far as they have because they had foreign investment in Canada. So they are really following practices that I am sure a lot of Canadians don't particularly support because they are damaging to them and, as Bob said, they are also damaging to the rest of the world because other countries may follow the example set by Canada.

Practices of this nature will also deter foreign investment in developing countries that could need that investment. If developing countries follow Canadian practices, they won't get the needed foreign investment. The problem is that while it hurts the Canadians, it hurts us as well. We have to point out to the Canadians exactly what damage their policies are causing.

As my statement points out, we do have an enormous relationship with Canada. In addition to being each other's largest trading partner at the end of 1980, $45 million or 20 percent of total United States investment abroad was in Canada and $10 billion or 55 percent of Canada's direct foreign investment was in the United States.

Bob pointed out the ties between our economies are so strong that any governmental efforts on either side to restrict or control investment could have major implications for both economies.

There are, however, and this is the big point, current significant differences in our economic approaches. This administration is committed to maintaining open capital markets for the free flow of trade and investment. The Trudeau government advocates a more interventionist approach to economic issues in general, and trade and investment issues specifically.

Rather than being based upon what we feel would be sound economic theories, the Canadian approach is more nationalistic, which translates

into increased Canadian control of the economy. As I said earlier, we do not object to Canada's desire to increase ownership in segments of the economy. That is their decision to make, whether we agree with it or not. But we do object to the measures that we feel are deliberately harmful to us and, particularly in the energy area, that we consider to be a change in the rules of the game in the middle of the game—and therefore a bad example for other countries.

As mentioned, the specific areas of concern which we have been attempting to address with the Canadians include—and I find this one of the major ones—the Foreign Investment Review Agency. This was established in 1973 to screen virtually all types of foreign direct investment in Canada.

FIRA bases its decision on one principal criteria: Is the foreign investment of significant benefit to Canada? We have serious reservations about the manner in which FIRA is being administered. We also object because that whole vague statement about "significant benefit" gives tremendous power to the Canadian bureaucracy to determine if something is not in the interest of Canada, which I think goes against our basic philosophy that foreign investment in general is good for both parties.

FIRA exacts legally enforceable commitments from firms investing in Canada, which distort trade and investment flows. But virtue of its review process, FIRA can restrict foreign entry by blocking new investment by new or existing foreign investors and by prohibiting the sale of Canadian assets to non-Canadian firms.

A situation that receives a lot of attention, that I must say is particularly galling and the Canadians never have a particular answer to it, is a case in which one American company is being sold to another American company and there are some Canadian assets involved in it. There is no particular threshold but they are going to try to stop or affect the whole merger simply because of the Canadian assets when nothing is changed in the Canadian economy as to the level of foreign ownership. The assets are going from one foreign owner to another.

It is a desire to extend bureaucratic control, and that is something that we have to do something about insofar as we can.

The national energy program, which we just discussed, is a serious concern. It is designed to increase Canadian ownership of Canada's energy sector, and legislation implementing the program is discriminatory and/or expropriatory and departs significantly from accepted international principles such as national treatment. It is the expropriations element and the back-in that we have been trying to deal with.

We did manage to get some small payments made, but based upon the kind of statistics we have, it is really less than 1 percent of the total value of what is being taken. In addition, the Energy Security Act, the other piece of implementing legislation, was introduced to the Canadian Parliament on February 28 and is expected to be enacted into law within a month.

It has several discriminatory measures. It has the PIP, which Bob has already discussed, which makes energy firms operating in Canada eligible to receive Federal incentives in excess of the 25 percent given to all companies only if they meet certain Canadian ownership and Canadian control criteria.

ESA also permits Canadian corporations to force minority foreign shareholders to sell their holdings in these corporations against their will and at potentially depressed prices. We think this is not only a terrible example of what could happen in Canada, but anywhere else in the world. I think it unconscionable that a foreigner investing in Canada in good faith may later discover that shares must be sold, possibly at depressed prices, or that shares can be taken back by the company. This is something that we will have to bring to the Canadian Government's attention as strongly as we possibly can.

This is what the U.S. Government is doing. It is stating, as all the members of the panel will be stating, that we are extremely concerned with the Canadian policy. We do not want to respond to these policies in a way that would be detrimental to U.S. national interests and would jeopardize the international economic system.

It would be detrimental to our own interest if just because they do not allow foreign investment in their country, we did not allow foreign investment in our country. They probably would like it; they would just as soon have the investments stay up in Canada even though it is to their detriment. So we have to work in other ways.

Various agency heads and other U.S. Government officials, including all of the panel members have had meetings with the Canadians that are continuing, and I think we are getting their attention.

We finally determined it had to be done much more in the multilateral context, and we have taken them to GATT and had an article XXII procedure started to complain in the GATT forum about the Canadian policies.

In addition, at the OECD, this is an issue that we have been bringing up. I'm sure Mr. Bale will discuss more on the OECD Ministerial which is coming up in May, and the GATT Ministerial which comes up in the fall. I think we are preparing all our papers, both bilaterally and in these multilateral forms, to build up to the ministerial that will come up in October to really make a concerted attack on these Canadian policies that we feel are discriminatory.

So as I stated, Canadian investment policies clearly cause concern but at the same time are a bit puzzling. The policies being enacted by the Government of Canada raise questions about its desire to attract foreign investment. Certain elements of the Canadian economy have also questioned the Government's method. Yet statements by public officials indicate that Canada welcomes foreign investment.

When you tell the Canadians that we really feel their policies mean that they don't like foreign investment, they disagee, but there seems to be a contradiction to this because they really are following policies that can deter this foreign investment. While these policies harm the U.S. interest, they are also, as we have pointed out, potentially very harmful to the Canadian economy.

The Government of Canada has decided, at least for now, that these policies are in their best interest. This administration is seriously disturbed by Canada's discriminatory investment policies. We have raised our concerns at the highest level in bilateral meetings.

We have taken Canada to the GATT. In addition, we have initiated further work on performance requirements and other discriminatory trading investment practices in the OECD and will propose that simi-

lar work be undertaken in the GATT. We will continue to work with Canada bilaterally but continue to pursue these problems in every forum possible, and welcome, of course, the opportunity to have hearings like this so we can bring it to public attention, not only in this country but in Canada, how concerned the United States Government is about these policies.

Thank you.

[Mr. Leland's prepared statement follows:]

PREPARED STATEMENT OF HON. MARC E. LELAND

I welcome this opportunity to appear before this subcommittee to discuss the current status of United States-Canadian economic relations. My comments will focus on what we have done to date to attempt to resolve those economic issues in contention between the United States and Canada, and how we might proceed in the future.

To put this discussion in the larger context, it may be useful to review the dimensions of our economic relations with Canada.

ECONOMIC RELATIONSHIP

The depth of United States concerns with the current trend in Canada's economic policies stems from the great importance of our economies to one another, and the magnitude of the bilateral trade and investment flows which these policies may jeopardize.

We are each other's largest trading partner. In 1980, U.S. trade with Canada exceeded $77 billion, accounting for nearly one-fifth of total U.S. foreign trade.

In relative terms, Canada is even more dependent on trade with the United States. Trade with the United States represents 70 percent of Canada's foreign trade.

At the end of 1980, U.S. investment in Canada totalled $45 billion, which represents 20 percent of total U.S. investments abroad.

Canada's private direct investment in the United States now totals $10 billion, or 55 percent of Canada's total foreign direct investment.

Thus, it is clear that the ties between our economies are so strong that governmental efforts on either side to restrict or control trade and investment have major implications for both economies.

It is for this reason that the current significant differences in our economic approaches is of such concern. This Administration is committed to maintaining open capital markets for the free flow of trade and investment. This is a cornerstone of our Economic Recovery Plan. Our international efforts are directed at eliminating, not creating, barriers to trade and investment, and at reducing government involvement.

The Trudeau government advocates a more interventionist approach to economic issues in general, and trade and investment issues specifically. Nationalism, which translates into increased Canadian control of the economy, is the central theme of the current government.

While we do not object to Canada's desire to increase Canadian ownership in segments of its economy—that is Canada's decision to make—we do object to a number of measures the Canadian Government is using to achieve its objectives. While these measures are objectionable in principle, they are even more disconcerting in that they are indicative of a general trend by governments to intervene in trade and investment flows. The proliferation of these measures undercuts our efforts to achieve a liberalization of the world economy.

SPECIFIC ISSUES OF CONCERN

There are a number of specific areas of concern to the United States regarding Canadian investment policy, which we have been attempting to address with the Canadians.

*Foreign Investment Review Agency*

The Canadian Foreign Investment Review Agency (FIRA) was established in 1973 to screen virtually all types of foreign direct investment in Canada. FIRA screening requirements thus apply before non-Canadians acquire control of

Canadian business enterprises, or establish new businesses, or undertake new activities unrelated to existing businesses. FIRA requirements even extend to mergers between parent companies outside of Canada that involve the transfer of ownership of a Canadian subsidiary. FIRA bases its decision on one principle criterion: Is the foreign investment of "significant benefit" to Canada? We have serious reservations about the manner in which FIRA is being administered:

FIRA exacts legally enforceable commitments from firms investing in Canada which may distort trade and investment flows.

These may include commitments, among other things to purchase a certain amount of Canadian goods for production and to export a certain share of Canadian production.

By virtue of its review process FIRA can restrict foreign entry, by blocking new investments by new or existing foreign investors, and by prohibiting the sale of Canadian assets to non-Canadian firms. A FIRA action to block the transfer of ownership of a Canadian subsidiary from one foreign firm to another could lead to the sale of foreign assets at depressed prices.

*National energy program*

Also of serious concern to the United States is the Canadian National Energy Program (NEP), which is designed to promote increased Canadian ownership of Canada's energy sector. Legislation implementing this program contains provisions that are discriminatory, and/or expropriatory, and which depart significantly from accepted international economic principles, such as national treatment. These provisions will adversely affect U.S. firms. We have specific problems with the two pieces of implementing legislation.

BILL C–48

Our problems with bill C–48, which was recently enacted, include:

Inadequate compensation for the 25 percent interest in oil exploration permits and licenses (and some) leases arrogated retroactively to the government;

The requirement that firms or consortia be 50 percent Canadian-owned and controlled to obtain a production license on Federal lands; and

Provisions designed to ensure that Canadian suppliers are considered on a "competitive basis". These provisions will be implemented by the Committee on Megaproject Industrial and Regional Benefits, which will determine why Canadian goods weren't purchased for a project and how the firm involved plans to ensure that Canadian suppliers are considered in the future.

ENERGY SECURITY ACT (ESA)

The other piece of implementing legislation, the Energy Security Act (ESA), was introduced to the Canadian Parliament on February 28, and is expected to be enacted into law within a month. The ESA contains several discriminatory measures, including the Petroleum Incentives Program (PIP). Under the PIP, energy firms operating in Canada are eligible to receive Federal incentives in excess of the 25 percent given to all companies only if they meet certain Canadian ownership and Canadian control criteria. The PIP will replace depletion allowances available to all firms.

The ESA also contains a number of other onerous provisions amending the Canada Business Corporations Act. These provisions permit Canadian corporations to force minority foreign shareholders to sell their holdings in these corporations to force minority foreign shareholders to sell their holdings in these substantial losses for United States and other minority foreign shareholders in Canadian companies in the energy sector. It also appears that the application of these provisions may have spillover effects on companies in other sectors, particularly foreign securities firms. Measures such as these distort international capital flows and certainly will not promote investor confidence in Canada.

RESPONSE OF THE U.S. GOVERNMENT

The U.S. Government is extremely concerned with Canadian policies. We do not want to respond to these policies in a way, however, which would be detrimental to U.S. national interests, and/or would jeopardize the international economic system. In our view, any actions to restrict foreign investment in the United States would adversely affect U.S. national interests and the domestic

Economic Recovery Program, and probably would not be effective in inducing changes in Canadian policies.

The United States has pursued its concerns with Canadian policies in a number of different fora:

Bilaterally, a number of high-level consultations have occurred.

Multilaterally, we have raised our concerns in the OECD and the GATT.

I will briefly review these initiatives.

BILATERAL INITIATIVES

On a bilateral basis, the Administration has held extensive consultations with the Government of Canada regarding its policies. These consultations have produced some changes but they are clearly not sufficient, and we are pressing for further modifications in the NEP and the FIRA. We are considering actions, therefore, under domestic law, including a possible action under section 301 of the Trade Act.

MULTILATERAL INITIATIVES: GATT AND OECD

The U.S. Government, as well as other countries, have expressed their concerns regarding Canada s trade and investment policies in both the GATT and the OECD. In the GATT, we initiated and held Article XXII consultations with respect to trade-related performance requirements associated with the FIRA. We are preparing a case under Article XXIII, under which a GATT panel would consider whether specific Canadian trade practices violate its obligations under the GATT. In addition, if certain aspects of the NEP are carried out in a discriminatory manner, we will consider initiating Article XXII consultations on the NEP.

"We have also raised these issues on several occasions in the OECD. As mentioned earlier, we believe that these measures instituted by the Canadian Government are indicative of a general trend by governments to intervene in trade and investment flows by applying discriminatory requirements. In our opinion, there needs to be more international consideration of the effect of these types of practices, and ultimately some discipline imposed on their use. Therefore, we pressed for further examination of these issues in the OECD, and were pleased with the recent agreement by the OECD Trade Committee to initiate a study on trade-related performance requirements. Additional work on this subject and the issue of investment incentives will also be done by the OECD Investment Committee.

In addition, the U.S. Government proposed at the March and September 1981 GATT meetings that the GATT undertake a systematic study of trade-related investment performance requirements and incentives, starting with the development of an exhaustive listing of these measures comparable to the NTB inventory developed for the Tokyo Round Negotiations.

OECD MINISTERIAL/ECONOMIC SUMMIT/GATT MINISTERIAL

There are a number of high level multilateral meetings in the coming months at which the United States plans to take the lead in opening a discussion of investment policy and discriminatory practices. These include the OECD Ministerial in May, the Economic Summit in June, and the GATT Ministerial in November. In our view, the proliferation of egregarious investment policies and practices make it essential to escalate this issue. Canada's policies are exemplary; but it is not the only country which employs such practices.

International institutions and multilateral rules have been developed in virtually every other area of international economic relations. We believe that it is time to begin to develop on a multilateral basis effective "rules of the road" in order to control these practices. Our ultimate objective at these meetings will be to reach agreement on this objective and to initiate related work towards this objective.

We intend to use the OECD Ministerial and Economic Summit to begin to generate developed country support for our initiative. At the GATT Ministerial, we hope to have the Ministers agree on the adoption of a work program which includes a major review of discriminatory and distorting investment policies. Included in this review would be an analysis of how the GATT might be strengthened to deal with trade related investment policies. This work program would provide the basis for proceeding with the development and negotiation of multilateral "rules of the road" for investment.

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CONCLUSION

Canadian investment policies clearly cause us concern, but are at the same time puzzling. The policies being enacted by the Government of Canada raise questions about its desire to attract foreign investment. Certain elements of the Canadian economy have also questioned the government's methods. At the same public statements by Canadian officials indicate that Canada welcomes foreign investment.

While these policies harm U.S. interests they are, as we have pointed out, also potentially very harmful to the Canadian economy. The Government of Canada, however, has decided that these policies are in their best interests.

This Administration is seriously disturbed by Canada's discriminatory investment policies. We have raised our concerns at the highest levels in bilateral meetings. We have taken Canada to the GATT. In addition, we have initiated further work on performance requirements and other discriminatory trade and investment practices in the OECD and will propose that similar work be undertaken in the GATT. We will continue to work with Canada bilaterally; and we will continue to pursue these problems vigorously in multilateral fora, as well, in an effort to resolve our differences.

Senator MATHIAS. Thank you very much, Mr. Leland. We will now hear from Mr. Waldmann.

## STATEMENT OF HON. RAYMOND J. WALDMANN, ASSISTANT SECRETARY FOR INTERNATIONAL ECONOMIC POLICY, DEPARTMENT OF COMMERCE

Mr. WALDMANN. Thank you, Mr. Chairman. It is a pleasure to be here today to discuss this important issue with you.

My statement does not reiterate some of the statistics which both Bob and Marc have referred to in their statements, recounted at some length, because I think your opening statement indicates the committee is well aware of the close interrelationship between our two economies.

It is also a little difficult to avoid being somewhat repetitious in stating some of the points which are of concern to us today, but I would like to just mention a few of the things which are discussed in my statement and perhaps touch on a few additional points.

I think we have taken the bilateral economic relationship for granted for a number of years because of our close political-commercial-cultural ties, our geographic proximity. But recent developments indicate that we can no longer pursue that course. In fact, I think our investment and trade relations over the last year or so have become increasingly strained, and it is Canada's growing reliance on government intervention to direct and control its national trade and investment patterns which conflicts with this administration's advocacy of free-market-oriented policy which I think is at the root of this problem.

The chief investment policy instrument that Canada has relied upon has been the Foreign Investment Review Agency, and I certainly agree with the specifics of the criticism which both Bob and Marc have leveled at that agency.

I would point out that a new agency, a Committee on Megaprojects, Industrial and Regional Benefits, has also been established, and that with this committee, Canada will assert even greater control over trade patterns by overseeing the purchasing practices of major project sponsors and insuring that a high level of domestic content is reflected in project procurement.

I believe the net effect of both FIRA and this new committee is the distortion of trade and investment flows between our two countries. I think U.S. firms have demonstrated that they are increasingly discouraged from investing in Canada. I think those companies that are operating in Canada face increasing operating costs as a result of these noneconomic performances.

Senator MATHIAS. Mr. Waldmann, I do not want to interrupt you, but I see people in the back straining a little bit to hear. Perhaps if you could speak directly into the mike.

Mr. WALDMANN. Fine.

While we have highlighted these two elements of the Canadian bureaucracy, FIRA and the CMIRB, there are numerous other devices which Ottawa now uses to interfere with normal patterns and flows of trade, and I just would mention the duty remission scheme, the Federal and provincial procurement practices, certain investment subsidy programs and other similar policies.

I believe the Canadian national energy program also has serious implications for U.S. trade and investment, and without engaging in too much repetition, we are concerned about the 25-percent back-in provision, the exploration incentive program, the PIP, and regulations to encourage the use of locally produced goods in the energy sector.

I think we are unanimous in our criticism of these elements of the Energy Security Act, and we hope that our concern will be recognized in Ottawa. The administration has not been idle. We have initiated both bilateral and multilateral actions, not to challenge the basic principles of the policy but rather the method of implementation.

We believe the method is discriminatory and we believe that it violates Canada's international obligations. I do not think that American companies or businessmen should be asked to foot the bill for Canadianization. Again, I will not recount, as my statement does, the consultations and the actions that we are taking.

I think I would only mention that we would certainly support the next step in GATT of going to an article XXIII panel procedure if we are not able to reach some kind of satisfaction under the article XXII consultation. I would also mention that the OECD has already undertaken a study program on the effect of performance requirements, and we would urge that this be on the agenda for the GATT Minsterial later this year and that it be taken up by the GATT as well.

I think that it is clear that this problem of the trading and investing relationship with Canada is a challenge facing the administration. We are attempting to manage it through our bilateral and multilateral contacts with Canada. We do recognize the sensitivity. We have a sensitivity to the Canadian concerns, but I believe the administration is also firmly committed to seeking a resolution to the problems that we have outlined.

Thank you.

[Mr. Waldmann's prepared statement follows:]

PREPARED STATEMENT OF HON. RAYMOND J. WALDMANN

I am pleased to be here today to discuss the current status of our economic commercial relations with Canada. This is a topic of vital importance and significance for our economic well-being. This Committee is acutely aware of our

close interrelationship, therefore I will not dwell on the numbers which substantiate it. Canada and the United States are each others' major trade and investment partners.

In spite of our extensive and in many ways unique ties, in past years we have taken our bilateral relationship for granted. Close political, commercial, and cultural ties, geographic proximity, and similarities in the operation and structure of our private sectors have served to direct our Government's attention away from bilateral economic issues to multilateral policy concerns. Recent developments are evidence, however, that we can no longer pursue this narrow course.

Our investment and trade relations have of late become increasingly strained. Canada's growing reliance on government intervention to direct and control national trade and investment patterns conflicts with this Administration's advocacy of free market oriented policies. In the first instance, Canada's growing ardor for pursuing policies and programs of economic nationalism (Canadianization) has resulted in discrimination against U.S. business interests. Second, and perhaps more importantly in terms of our long term interest, we believe that the methods used by Canada to enforce economic nationalism pose a threat to the international trading system by erecting barriers to cross-border flows of trade and capital. The discriminatory aspects of Canadianization policies are most evident in Canadian investment and energy policies.

As its chief investment policy instrument Canada has relied upon the Foreign Investment Review Agency (FIRA). FIRA has been established to screen foreign direct investment flowing into Canada. Foreign investment proposals must receive FIRA's stamp of approval that "significant benefits" will be derived by Canada from any proposed undertaking. The majority of projects are approved by FIRA. However, in approving projects, FIRA imposes obligations in the form of legally-binding performance requirements that, among other things, set export quotas, import ceilings, and local sourcing requirements. In the context of this trade policy, Canada has instituted the Committee on Megaprojects, Industrial and Regional Benefits (CMIRB). With CMIRB, Canada also is striving to assert greater control of trade patterns by overseeing the purchasing practices of major project sponsors, and thereby ensuring that a high level of domestic content is reflected in project procurement.

The net effect of FIRA and CMIRB policies is a distortion of trade and investment flows often to the detriment of U.S. interests. U.S. firms have been discouraged from investing in Canada because they would not or could not assume obligations stipulated by FIRA. Many of those firms that have invested are experiencing increasing operating costs as a result of noneconomic performance requirements. And, U.S. firms exporting to Canada have seen their export prospects diminish as a direct result of FIRA's and CMIRB's "buy Canada" stipulations.

While I have highlighted these two elements of the Canadian bureaucracy, there are numerous other devices which Ottawa uses to interfere with the normal flow of trade: duty remission schemes, federal and provincial procurement practices, investment subsidies and the like.

Canada's National Energy Program also has serious implications for U.S. trade and investment. While the Secretary of the Interior did not find Canada a "nonreciprocal" nation under the meaning of the Mineral Lands Leasing Act of 1920, Secretary Watt carefully noted continuing Administration concern with regard to Canada's National Energy Program (NEP). The NEP's objective to achieve 50 percent Canadian ownership of the oil and gas industry in Canada by 1990 is being pursued through discriminatory policies and practices. These policies include the 25 percent "back-in" provision, an exploration incentive program based on the level of a company's Canadian ownership and control, and regulations to encourage the use of locally produced goods. The recently introduced Energy Security Act will complete the implementing legislation required for the NEP. In addition to our previous concern, this legislation appears to have the potential for forcing divestiture of stock in Canadian corporations where Canadian ownership and control requirements exist. Currently, this only applies to the energy sector, but we view this seemingly open ended provision with grave concern. We have consulted with the Canadian Government on this issue—our most recent talks taking place last week. We expect to have additional discussions on the subject. These issues are of particular concern to us because U.S. companies currently own some 66 percent of Canada's gas and oil industries.

This Administration has not and will not sit by idly and watch our companies and businessmen bear the brunt of costly and inequitable restrictions in the

Canadian market. We, of course, do not challenge Canada's right to Canadianize its energy sector or to screen foreign investment—even though we believe that such policies are not efficient and do not result in maximum resource utilization. But we do challenge Canada's methods for implementation of nationalistic programs when these methods (a) discriminate against and unfairly burden U.S. interests and (b) violate Canada's international obligations. American companies and American businessmen should not "foot the bill" for Canadianization. NEP, FIRA, CMIRB and other restrictive programs in such areas as auto trade, banking, transportation and border broadcasting discriminate against U.S. interests, and in our view violate Canadian international obligations for maintaining open trade and investment policies.

I would like briefly to outline for you the actions that we have taken and are taking to protect U.S. interests and to ensure Canadian adherence to its international commitments. This strategy has commanded the attention of senior Administration policymakers and has been developed in the course of deliberations by the President's Cabinet Council on Commerce and Trade and the Trade Policy Committee.

First, we have held extensive bilateral consultations with the Canadians in which we have highlighted our concerns about discriminatory Canadian economic policies. As I have already mentioned, we met with a Canadian delegation last week to review the provisions of the Energy Security Act which is now before Parliament. A delegation also traveled to Ottawa last week to present our concerns with the respect to FIRA and provincial obstacles to trucking operations in Canada. Although to date these consultations have not resulted in significant modifications to announced programs such as FIRA and NEP, there is some evidence that the Canadians have paused in their implementation of certain programs. For example, the Canadians have announced that NEP-type programs will not be extended to other sectors; and an administrative review of FIRA operations has been undertaken. We plan to continue this bilateral dialogue to sensitize further the Canadian government and public to our concerns, and to push for concrete revisions to objectionable Canadian policies.

In a multilateral context, we are pursuing an aggressive strategy to ensure that Canadian policies are consistent with Canada's international obligations. Specially, with respect to FIRA we have invoked our rights under the GATT to challenge those practices that we believe violate Canada's international trade obligations to accord national treatment to U.S. exports. In February we held official consultations under GATT Article XXII procedures. Unless Ottawa undertakes to modify its pertinent FIRA practices, we plan to present a GATT case against Canada under Article XXIII provisions sometime this spring. An Article XXIII action will involve the establishment of an international panel to investigate U.S. complaints regarding Canadian FIRA practices.

In the case of NEP, during discussions in OECD's XCSS and Investment Committees we have challenged Canadian policies as a derogation from the 1976 OECD declaration on national treatment of investment. These discussions are continuing and it is noteworthy that other OECD members have joined us in raising concerns about the NEP.

In terms of unilateral action, the Department of Commerce, in conjunction with USTR, has undertaken a survey of hundreds of U.S. firms to ascertain details regarding the performance requirements that have been assigned by FIRA. This information is currently being compiled and analyzed. It will be used, as appropriate, to strengthen our prospective case in the GATT and to provide the basis for our consultations in the OECD. We are also maintaining close contact with our industry sector advisory groups (ISAC's) to keep them apprised of new developments and recent USG initiatives.

Finally, I might also point out that should our bilateral or multilateral efforts to eliminate discriminatory Canadian practices fail, then we will proceed to explore the merits of pursuing unilateral measures available under U.S. law such as 301 action. We must, of course, proceed cautiously in this regard—first to ensure that we do not do damage to U.S. interests in taking such action; and second, to ensure that we do not do harm to the international trading system. Nevertheless, there should be no doubt that we will use all appropriate legal means to defend our interests.

There has recently been considerable discussion in the U.S. of the issue of reciprocity. As a matter of principle, I support the notion that the markets of our trading partners should be as open as our own market here in the United

States. However, it is important to draw a distinction between our current strategy vis-a-vis Canada and the reciprocity debate. In challenging Canadian nationalistic policies bilaterally and multilaterally, we are not subjecting Canada to a reciprocity standard; rather we are simply seeking Canadian adherence to its existing international obligations.

I should reemphasize that our concerns relative to Canadian actions extend beyond our bilateral relationship. Discriminatory trade and investment policies by Canada—an economically developed country and a key player in the international economic system—are an incentive for other countries, particularly LDCs, to derogate from upholding market principles. Canadian policies have highlighted the need for extending the discipline we have negotiated in the area of trade in goods to investment. I am pleased to report to you that agreement has been reached in the OECD to pursue the general issue of trade-related performance requirements and hope that agreement can also be reached in GATT to undertake a similar study.

In conclusion, it is clear that one of the major challenges facing this Administration is to manage successfully our bilateral relationship with Canada through the current difficult period. This is a political as well as economic imperative. While we must exhibit sensitivity to Canadian concerns, we also must draw a line when it comes to protecting U.S. interests and the international economic system from the challenges of Canadian policies. This Administration is firmly committed to fulfilling this mandate. I believe that our Canadian allies understand and respect this position.

Senator MATHIAS. Thank you, Mr. Waldmann.

And now Mr. Bale.

## STATEMENT OF HARVEY BALE, ASSISTANT U.S. TRADE REPRESENTATIVE FOR INVESTMENT POLICY, U.S. TRADE REPRESENTATIVE OFFICE

Mr. BALE. Thank you, Mr. Chairman.

I welcome the opportunity to come before you and your subcommittee to address the subject today.

My prepared testimony and that of my colleagues deals rather thoroughly with that of energy investment related issues, which today are the major contentious problems in United States-Canadian economic trade relations.

In regard to these relations on the positive side, the United States-Canada trading and investing relationship is the largest and most extensive of any two countries in the world. In 1981, two-way trade approached $87 billion, accounting for almost 20 percent of United States world trade and more than 70 percent of Canada's total trade.

There is a high degree of economic integration between our two countries, and this is exemplified by the large volume of duty-free trade. In 1979 more than three-quarters of United States imports from Canada entered the United States duty free, while 70 percent of United States exports to Canada were accorded duty-free treatment.

The average United States tariff applied to Canadian imports has been 1.3 percent, compared to an average Canadian tariff rate of 4.3 percent applicable to United States exports. As a result of the concessions agreed to in the Tokyo round, duty-free trade between our two countries should approach 80 to 90 percent by 1987.

I think what this represents, Mr. Chairman, is an extensive volume of duty-free trade without a formal free trade agreement between our two countries but the effects of an evolution between our two countries.

On the negative side, major problems have been created for the United States by FIRA and its practices of engaging in legally enforceable performance standards that distort trading investment, FIRA's screening of inward investment and its interference with the transfer of foreign-held Canadian assets.

We are also very much concerned about the national energy program with its discriminatory, retroactive, and inadequate compensation features.

Now, on the Canadian side there is great political sensitivity about foreign ownership of Canadian assets, which in the manufacturing sector approaches 50 percent and in the energy sector exceeds 60 percent. In addition, the current Canadian Government appears bent on increasing the Canadian Government's role in the Canadian economy.

The real issue before the United States is how can we, how should we, and how do we intend to best deal with these problems. We must deal with them not only because of the particular problems that Canada's policies present to our interest but also because of the example Canada is setting in not living up to its international obligations that we would rather not have other countries follow.

In terms of the methods of approach to this problem, we do have a bilateral problem. We are utilizing bilateral techniques. We have had, as other speakers have mentioned, frequent bilateral discussions and communications for more than 1 year with some, albeit quite limited, success. We should, however, continue such an approach.

Second, in a bilateral context we have taken some of Canada's practices to the GATT. We are utilizing GATT procedures to bring the attention of the GATT to what we think are clear violations of several articles of the GATT and the practices of the Foreign Investment Review Agency.

Under these procedures we are probably headed toward an arbitration panel, although at any point along the road a settlement could be reached if Canada meets our concerns. The Canadians themselves appreciate the use of the GATT. They have in the past and now are in the process of bringing GATT cases against the United States, and on this issue Canadians at the highest level of their Government have told Ambassador Brock and others that they will abide by the GATT decision process.

We must recognize that the GATT will not deal with all or perhaps not even most of our problems, but for the first time, we have taken a trade-related investment issue to the GATT, and this is an important precedent. The problem we are having with Canada is illustrious of a broader multilateral weakness in the international economy.

The problem is that Canada is under no international sanctions according to any existing and binding rules in the investment field regarding its policies that are clearly in violation of certain agreed principles of treatment of international investment. Canada has multilateral obligations under the OECD, and the United States as well as other countries have raised the problem of the massive derogation that Canada's national energy program represents from the 1976 Declaration on National Treatment to which Canada is a party.

However, there are no sanctions under the OECD other than under international pressure, and while international pressure may be effec-

tive in certain circumstances, in many other cases it may not be. We need to explore in the 1980's new forms of international rules for investment. A start can be made in the GATT Ministerial in the fall in addressing the trade-related investment practices.

Canadian problems are not unique to Canada. National treatment, barriers to investment, and trade-distorting performance requirements are widespread among both developed and developing countries. While working both bilaterally and multilaterally to arrive at solutions to our problems, we will have to continue to evaluate the impact of Canada's investment and energy policies and United States economic and commercial interests and assess what we can do under United States law to address our concerns.

In the administration we are continuing to explore possible further approaches to the investment and energy problems that we have with Canada. Certainly one thing we should take into account, however, is that Canadian policy will clearly be affected by the Canadian Government's evaluation of the internal cost of its current and prospective policies.

There appears to be mounting internal concern in Canada about these policies. For example, the president of a major Canadian company recently said,

> Because of the NEP, the Canadian energy industry is smaller and weaker and less capable of finding the new energy sources that Canada will need to achieve to arrive at self-sufficiency.

In addition, some of the Canadian press have stated that—

> Ottawa's pursuit of the Canadianization objective has had a devastating impact on the Canadian dollar, and the National Energy Program and the attitude of the Canadian Government towards investment, both domestic and foreign, have resulted in a huge outflow of capital from Canada.

I should note in passing that despite Canada's internal need for investment capital, according to OECD and U.N. sources, since 1973 Canada has had a net outflow of direct investment. Canada will have to choose between its current political and long-term economic needs.

Various members of the administration believe that positive solutions are possible. We need to work hard to find them and we should do this in order to preserve the extensive and generally good economic and trade relations that Canada and the United States have for so long enjoyed.

Thank you, Mr. Chairman.

[Mr. Bale's prepared statement follows:]

PREPARED STATEMENT OF HARVEY BALE

I am pleased to be here today to present the views of the Office of the United States Trade Representative on the current state of United States-Canada economic relations. My testimony today will focus on investment and energy issues.

The United States-Canada trading and investing relationship remains the largest and most extensive of any two countries in the world. In 1981, two-way trade approached $87 billion, accounting for almost 20 percent of American world trade and more than 70 percent of Canada's total international trade.

The high degree of economic integration between our two countries is exemplified by the large volume of duty-free trade. In 1979, 76 percent of U.S. imports from Canada entered the United States duty-free, while 70 percent of U.S. exports to Canada were accorded duty-free treatment. The average U.S. tariff applied to

Canadian imports in 1979 was 1.3 percent compared to an average Canadian tariff rate of 4.3 percent applicable to U.S. exports. Looking only at dutiable trade, the average U.S. tariff rate applied to Canadian imports was 5.5 percent in 1979; the comparable Canadian rate applied to U.S. exports was 14.1 percent.

As a result of concessions agreed to in the Tokyo Round of multilateral trade negotiations (MTN), duty-free trade between our two countries should approach 80–90 percent by 1987. In those negotiations, Canada agreed to reduce its tariffs on U.S. exports by an average of approximately 40 percent.

At year end 1980, U.S. direct investment in Canada was valued at $44.6 billion. This figure represented 21 percent of total U.S. foreign direct investment abroad. Of this total, $3 billion was in the mining and smelting industry, $10.6 billion in the petroleum industry, $18.8 billion in manufacturing industry, $10 billion finance, insurance and trade, and the remaining $2.2 billion in other areas such as banking and transportation.

In 1965, Canadian direct investment in the United States was valued at $2.4 billion. By 1980, the value had increased to $9.8 billion. This figure represents only 15 percent of total foreign direct investment in the United States, but more than 50 percent of Canadian foreign investment.

As these statistics indicate, the United States and Canada have developed a strong trade and investment relationship. Nevertheless, we are faced today with a difficult period in the United States-Canadian economic relationship as Canada is in the midst of efforts to enhance the role of local and government enterprise in its economy. While we respect these efforts, we must insist that they be pursued in a non-discriminatory manner, consistent with Canada's international commitments.

The underlying cause of the current tension in our bilateral economic relations is the result of significant differences in our two government's approaches to economic questions. This Administration maintains a free market approach to trade and investment. We are committed to maintaining free markets as a central element of our domestic economic program.

On the other hand, the Trudeau government advocates a much more government interventionist approach to economic problems. In addition, nationalism, which translates into increased Canadian control of the economy, is another basic theme of the Canadian Government's economic program. We do not object to Canada's desire to "Canadianize" its economy. Whether we agree with it or not, this is their choice to make. However, we are concerned about a number of the policy measures that the Canadian Government proposes in order to achieve that objective. These policies are particularly troublesome as they undercut current U.S. efforts to persuade other countries, especially the developing world, to move away from such measures, and they increase pressures for the United States to adopt similar policies—to the detriment of Canada, the United States, and the world trading and economic system as a whole.

The major issues of concern to us are the National Energy Program, the operation of the Foreign Investment Review Agency, and the operation of the Committee on Mega-Project Industrial and Regional Benefits.

*NEP*

On October 28, 1980, as part of its budget message, the Canadian Government announced a far-reaching National Energy Program (NEP), designed to ensure at least 50 percent Canadian ownership of the oil and gas industry in Canada in 1990 and full Canadian control of "several" large, foreign-owned oil and gas companies.

The two pieces of legislation designed to carry out this policy are the Canada Oil and Gas Act (Bill C–48) and the Energy Security Act (Bill C–94). The Canada Oil and Gas Act was passed by Parliament in late December. The Energy Security Act was introduced in Parliament on February 26. The U.S. Government is concerned about provisions in both Acts which adversely affect our commercial and investment interests.

*Canada Oil and Gas Act*

The two major measures embodied in Canada Oil and Gas Act that concern us are the 50 percent Canadian participation requirement and the back-in provision.

All production leases on Canadian Federal lands must have at least 50 percent Canadian ownership. This regulation led to the U.S. Department of the Interior's investigation as to whether or not Canada should maintain its reciprocal status

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under the Mineral Lands Leasing Act of 1920. After allowing for public comment, Interior, using a strict interpretation of the law, has found Canada to be reciprocal.

The back-in, while not discriminatory like the ownership requirement, raises the question of equity for U.S. investors. The 25 percent crown share back-in is applied retroactively. For leases on which oil or gas was discovered on or before December 31, 1980, back-in provides that the license holders are entitled to a payment of 25 percent of their pre-1981 eligible investment for the purpose of compensating for the 25 percent Crown share.

Our interpretation is that the Canadian Government is, after the fact, taking a share of only the successful discoveries and paying only for the costs incurred in developing these successful wells. To add insult to injury, they will be paid with the money they receive from the sales of that well when it goes into production.

The Canadian argument is that the back-in should not be viewed as an expropriation, that the Canadian rules have always been different than ours and finally that the new land management regime is fair to industry and compares favorably with the Energy regimes in other oil producing countries.

We have also learned that, as a result of the Canada Oil and Gas Act, existing exploration permits on Canada lands would be renegotiated with the objective of returning 50 percent of these lands to the Government, and that these recovered lands would be disposed of by tender preferentially to high Canadian Ownership Rate Companies. This would be in addition to the 25 percent back-in already scheduled for the same lands.

ENERGY SECURITY ACT

The ESA proposes amendments to six existing statutes. Two, the Petroleum Incentives Program Act and the Determination of Canadian Ownership and Control Act, could have considerable impact on the competitive posture of U.S. energy concerns relative to Canadian energy concerns. Since eligibility for these subsidies is limited to businesses that are Canadian-controlled (at least 50 percent Canadian owned), U.S.-controlled energy concerns likely will be placed at a significant competitive disadvantage if these two proposed Acts are enacted.

The Petroleum Incentives Program Act establishes a Petroleum Incentives Program (PIP) to provide subsidies for Canadian-controlled businesses. The Determination of Canadian Ownership and Control Act prescribes the requirements that determine the degree to which businesses are Canadian-controlled, measures in terms of the Canadian ownership rate (COR) and the Canadian control status (control status).

The primary purpose of the PIP is to provide grants, or "incentives", to qualified Canadian energy concerns that engage in specified oil and natural gas exploration and development activities. The draft ESA provides that an applicant that satisfies the Canadian ownership requirement rate (COR) and is considered eligible under the Canadian control status, is entitled to receive an incentive for a percentage of its "eligible costs or expenses." This is defined as including "eligible asset costs," "eligible development expenses" and "eligible exploration expenses." Applicants with higher COR's are entitled to proportionately larger incentives, and also qualify for incentives for a greater number of eligible activities.

For example the draft ESA provides a base incentive of 25 percent to all companies, while leases with a 67 percent or greater Canadian ownership are to provide additional incentives of up to 55 percent of the eligible exploration expenses, 20 percent of the eligible development expenses, and 20 percent of the eligible asset costs.

The Canadian Government recently sent down a group of officials to Washington to brief U.S. officials on the Energy Security Act. One of the questions we posed at the meeting was how was the Canadian Government going to define and implement Canadian control. Their response was that the test of control will be based on the definition of control in FIRA, which is used to determine the individual or group of individuals who exercise effective control. Noneligible companies included in this definition could include those companies where foreign shareholders taken together account for at least 25 percent of the voting shares of a Canadian corporation, the shares of which are publicly traded. Additionally if any one noneligible person (foreign company or person) owns 5 percent or more of a Canadian Corporation it could be considered foreign controlled.

Since many U.S. individuals invest in Canadian companies, there exists the possibility that many Canadian companies would be considered non-eligible under the control definition. To get themselves out of this box the Canadians propose amending the Canada Business Corporations Act.

These amendments would (1) allow Canadian companies, upon a two-thirds majority vote, to force the foreign shareholders to sell their shares or (2) to set up a new class of stock. This new class would only be available to Canadian buyers and would be combined with the old class of stock for the purpose of determining the control status of the company.

These proposals along with the other Canadian investment policies are bound to have an impact on future foreign investment in Canada. The Engineering and Mining Journal had, in its February edition, an article in managing political vulnerability. One point that was made was the lag between the reality of new government policies. Dr. Warnock Davis, an experienced international investment advisor, was quoted as saying:

"Popular wisdom in evaluating countries simply is not useful. For instance, Canada on a risk-rating basis must be almost the best in the world. All of the services rate Canada way up there with West Germany and the United States. Yet, ask a mining company or an oil company about Canada today. A corporation with a nickel deposit in Malaysia has a lot lower socio-political vulnerability that an asbestos company with investments in Quebec. A corporation simply must go beyond popular wisdom when evaluating the special and political risk of mining investments outside the bounds of its home country."

### FOREIGN INVESTMENT REVIEW AGENCY (FIRA)

The Foreign Investment Review Agency (FIRA), which has been in existence since 1974, was established to increase Canadian control and ownership of investment in Canada and to ensure benefits for Canadian firms from such investment. While we do not question Canada's sovereign right to screen new foreign investment, we do find its administration objectionable:

*1. Import, Export, and Distribution Requirements*

As a condition for new foreign investment, FIRA signs legally enforceable agreements with foreign investors specifying when firms must buy Canadian goods, in violation of the provisions of GATT that require equal treatment between imported and domestic products (Article III). FIRA may also require firms to export a specific share of their Canadian production, which can distort trade flows. Foreign firms may also be prevented from distributing their products in Canada, which can seriously restrict trade. The United States is seeking a complete elimination of these requirements, and is in the process of challenging the validity of FIRA trade-related leadership in the GATT. We intend to pursue our full GATT procedural rights, unless Canada provides an adequate bilateral solution.

*2. Takeovers*

FIRA prevents foreign firms from freely selling their assets in Canada to other non-Canadian firms, even though there is no increase in foreign ownership. This can sharply reduce the value of foreign-owned assets in Canada. The United States is seeking a change in the FIRA process to permit all takeovers that do not increase total foreign-owned assets, so long as the purchaser is not objectionable on grounds such as moral turpitude.

### COMMITTEE ON MEGA-PROJECT INDUSTRIAL AND REGIONAL BENEFITS

On August 27, 1981, the Canadian Government announced a new system to administer the industrial benefits provisions of the NEP. A key element of this new system was the establishment of a Committee on Industrial and Regional Benefits (CIRB), subsequently renamed the Committee on Mega-Project Industrial and Regional Benefits (CMIRB), which is charged in part with ensuring that owners or sponsors of major projects in Canada, generally those above $100 million in capital investment, take steps to meet the Government's expectations.

The Canadians have consistently told us that they have no intention of utilizing CMIRB to restrict imports. They maintain that multinationals, primarily out of habit, ignore Canadian suppliers. The Canadians assert that the purpose of CMIRB is to give Canadian firms fair access to major projects in Canada.

We have stressed to the Canadians that if CMIRB operates in a way where oil and gas firms will be persuaded to buy from Canadian sources so long as these sources are "competitive" with foreign suppliers, it could be argued that this practice would result in treatment of imported products which is less favorable than that of domestically produced goods—raising the question of Canada's conformity with the obligations of GATT Article III.

We are closely monitoring the activities of CMIRB, and will strenuously object to the imposition by CMIRB of any requirements that companies report on or justify their use of foreign goods and services or any policies which would prevent firms from making decisions relating to sourcing of purchases on commercial grounds. We are prepared to actively pursue our rights under the GATT if that becomes necessary.

EFFORTS TO RESOLVE OUR DIFFERENCES

Since the very beginning of this Administration's tenure, we have given high priority to the problem of how best to address the issue of Canadian investment, trade and energy policies. Bilateral discussions between senior U.S. and Canadian officials have been underway for over a year in an effort to resolve our differences. As recently as March 1, U.S. and Canadian representatives met to discuss the major elements of the Energy Security Act. These discussions have led to a better understanding of each country's position, and I believe that the Canadian Government recognizes that certain of its policies are creating problems in our relations. In that regard, the Canadian budget presentation of November 18 was helpful. That budget publicly committed the Government not to expand NEP policies to other sectors and not to expand, for the time being, FIRA"s mandate.

While these commitments were certainly welcomed, and represented a positive step by the Canadian Government, many of our concerns over the current operation of FIRA and the NEP remain.

*Other bilateral issues*

We are also faced today with a series of less publicized, though important, bilateral trade issues affecting our relationship which run the whole range of economic activity between our two countries. Chief among these issues are (1) Canada's pharmaceutical patent policy, (2) trucking, (3) lumber, (4) potatoes.

Section 41 of the Canadian Patent Law provides that any company may request the Canadian Commissioner of Patents to provide a compulsory license for pharmaceutical patents and that only a nominal royalty of four percent is paid. The effect of this law is to permit companies who have made no contribution to the costly and risky research and development process to invade the market of the innovator, thereby lessening his return and ultimately his incentive to invest in new product research and development. Bilateral consultants are currently underway and we are evaluating a GATT complaint.

The U.S. trucking industry has complained that they are denied reciprocal access to the Canadian market. The Canadian trucking sector is more highly regulated than the U.S. industry, and regulation in Canada is accomplished at the provincial level as opposed to the federal level in the United States. A preliminary analysis indicates that the application of the regulation in Canada does not discriminate between foreign and domestic operators; however, foreign operators wishing to establish a business presence in Canada may be blocked by FIRA. Bilateral consultations have recently been held on this matter, and the Interstate Commerce Commission is conducting an investigation.

Both the U.S. lumber and potato industries are concerned about the level of imports from Canada. The U.S. International Trade Commission is conducting separate investigations pursuant to Section 332 of the Tariff Act of 1930 into the competitive condition's affecting these industries.

We are continuing to discuss our concerns on all of these matters both bilaterally and internationally. We are actively pursuing certain of our concerns in the GATT and in the OECD. We are also reviewing the applicability of U.S. laws, such as section 301 of the Trade Act of 1974, to these matters. We are hopeful, however, that we can reach a resolution of our differences short of direct confrontation.

Thank you, Mr. Chairman, for the opportunity to discuss these extremely important issues with the Subcommittee. I have brought with me today Mr. William Merkin, Director of Canadian Affairs at USTR, who is knowledgeable on the wide range of U.S.-Canadian trade issues. We would both be pleased to address any questions which you or members of your Subcommittee may have on the United States-Canadian economic relationship.

Senator MATHIAS. As I indicated in my question to Mr. Hormats, FIRA has existed at least since 1974 and it was the subject of some discussion in Canada before that time, but it was not until January that the United States asked for GATT consultations. Is there any record of action on the part of the United States or expression of concern on the part of the United States in the nearly 10 years that intervened between those two events?

Mr. LELAND. As I said, when I looked at my files and at Bob's, there was an enormous amount of bilateral pressure and meetings and discussions and groups trying to do something about it. Mr. Chairman, as you pointed out, it was unclear when it first got started exactly what was going on here. You could see the potentially bad effects of it, and I think it was felt because of the relationship between the countries, that one had to use whatever persuasion you possibly could to do something about it.

You also had a change of government in Canada, with a different attitude toward using FIRA. When the Trudeau government came back in, however, there were several disturbing cases—if you look at the recent FIRA cases, the Apple Computer and the Gannett newspaper, they are particularly annoying. These are the ones where they put in the very strong performance requirements to buy things. For instance in the Gannett case, to be allowed to operate in Canada, Gannett has to buy all the pulp for its newspapers in Canada.

It became of greater and greater concern, and finally we went to the GATT. But I think everybody here would agree that since the beginning there has been constant pressure on the Canadians and this Congress itself has had many hearings on the subject.

Senator MATHIAS. The reason I keep coming back to this and asking you to repeat yourself, I am concerned that it may be alleged that the United States has been guilty of lapses and we have slipped, not on our rights in the sense that lapses apply to interest, but at least that we have allowed by silence to give some implication of acquiescence.

Mr. WALDMANN. Mr. Chairman, I do not think that is the case. I think we were terribly concerned about the possible extension of FIRA regulations which were announced as a possible policy of the Trudeau government about a year and a half ago. As Marc has said, the recent cases, particularly over the last 6 months or so, have shown a more objectionable set of requirements being imposed on companies, but I am sure that our record of opposition has gone back over many years.

Senator MATHIAS. There is in the world today an expression of concern about protectionism among trading nations heard in respect to many elements of trade. We are concerned that we ourselves may be forced by events to resort to some form of protectionism, although most people do it as a last resort.

Of course, protectionism can take a number of forms. It can apply to trade or it can apply to investment, and the general and orthodox view as far as trade is concerned is that ultimately it hurts the country that invokes it in some way or other.

Now, what effect do you think FIRA is having on foreign direct investment in Canada? Are investors discouraged to such a degree that there is a discernible negative effect on the rate or on the character of investment flowing into Canada?

Mr. HORMATS. Let me just try that, and I am sure my colleagues will want to say something as well. In a way, it is somewhat hard to

measure the current impact of FIRA. I have talked to a number of companies which have demonstrated an interest in investing in Canada. Then they find out the sort of conditions that are generally imposed by FIRA and they become discouraged to the point of not even developing the investment proposal for presentation to the Canadian authorities.

FIRA has built up a record, as Marc indicated, where there are certain conditions which companies assume will be asked of them, and they simply recognize that and don't make the initial proposal. So there is a large, although difficult to measure, discouragement factor.

Then there are investments which do take place, and they take place under FIRA-imposed conditions, and what tends to happen to those investments is that that gets to the second point you made, and that is the trade impact. It is quite clear that for the most part, investors will buy and source where the sourcing is most efficient. If it is efficient in Canada, they will buy Canadian. If they can get it cheaper or less expensive or a better product elsewhere for their investment, they will get it elsewhere.

What FIRA tends to do is to cause certain purchases to be made in Canada which might not otherwise be made on grounds of quality or efficiency, and to the degree that is done, to the degree FIRA requirements lead to decisions which are less than efficient and less than market oriented, you also reduce the efficiency of the overall investment. So there is that factor as well.

Now, some firms are willing to do that in order to have the opportunity to invest in Canada. Others are simply unwilling to undertake or suffer the inefficiency cost of certain FIRA requirements. So you have those elements. It is very difficult to quantify, but one can give you a number of examples of this.

I should say also, to be very frank, that sometimes companies which have had to go through the FIRA process and have certain conditions imposed on them do not want to talk to the U.S. Government about it because FIRA is really run by a number of people at official level, and to the extent companies talk about it, they fear, and they have told us so, that there will be certain penalties the next time they go to FIRA for discussions of the conditions of their investment.

Mr. BALE. If I might amplify, I mentioned a quote in my prepared testimony by Dr. Davies, an Australian national who does a considerable amount of investment advising out of New York City and has advised investors largely in developing countries but also in some developing countries.

In a recent article out of the Engineering and Mining Journal, in an interview he talked about the cumulative impact of policies, and I think that is what is happening in Canada. Over a period of time while the FIRA has been in effect, some 8 years, that plus the national energy program has had quite an impact on the way investors really evaluate the investment climate in Canada.

He talks about widened perceptions here. He mentions that popular wisdom in this area is difficult. He mentions that all of the investment services generally rate Canada pretty highly, along with West Germany and the United States, as an investment environment, but when you get down to the microlevel and ask a mining or an oil company

about Canada today, he would say that a corporation with a mineral deposit in Malaysia has a lot lower sociopolitical vulnerability than asbestos companies with investments in Quebec.

So I think, as Bob Hormats has indicated, it is very difficult quantitatively to assess the impact of flows on investment. Nonetheless, the cumulative effect of policies—it is distressing to us as investors in a neighboring country to see this—is negative on investment in Canada. There have been some pullouts recently, sellouts, not only in the energy sector but in other sectors, and I think the Commerce statistics, something that Dr. Waldmann's people put together last year, indicated that on a certain measure of investment flows of U.S. investment in Canada, there had been a negative flow for the first time on the equity and intercompany accounts basis.

There might be reinvested earnings that are still up there. The total effect may be positive. But in terms of new money, it was negative.

Senator MATHIAS. In layman's terms, then, money is coming out of Canada into the United States instead of following the historic channel of moving the other direction.

Mr. BALE. That is right. There still may be reinvested earnings there that will show up as positive, but according to those statistics, there is not a set flow of new funds going up.

Mr. WALDMANN. Mr. Chairman, if I may comment on that last point. While the macroeconomic statistics show that, we have also done a survey of American companies which have been operating in Canada to assess the kinds of conditions which FIRA has been imposing and the impact of those on the individual company operations. This analysis is continuing now. When we have a report, we will be glad to share it with the committee.

Senator MATHIAS. Of course, from a Canadian point of view, that may be a sign of success if that is the object of the program, and they are entitled to have that policy if that is the policy they want, encouraging less rather than more foreign investment in the country. They have the ability to adopt that kind of policy, but I am just wondering whether we are reacting because of the fact that we feel so close to Canada and are geographically so close to Canada.

I do not think we want to emphasize the kind of nature of our relationship which Prime Minister Trudeau has said is like sleeping next to an elephant. How do other countries feel about this? What is the reaction among other trading partners of Canada? What is the reaction among other nations that traditionally do invest overseas?

Mr. WALDMANN. The investment policies of Canada have been discussed in the Investment Committee of OECD, and we have had concern expressed by German and British and other representatives of that committee to the same policies and concerns we have, but I do not think it is fair to say Canada is trying to prevent all foreign investment.

The most recent budget message suggested that they recognized the importance of foreign capital and technology and investors to the development of their oil and gas and natural resources. It was very explicit on this point, and it was attempting to say yes, we have an opportunity here but we want it under our own conditions and on our own terms.

Senator MATHIAS. I would not want to try to express the view of this committee, but speaking as a personal matter, I would say that it appears to me that policies of both free trade and free investment are the healthiest kind of policies for the global economy. But if we see restrictions in investment policy, just as is natural when we see restrictions in trade policy, we usually react in some way, and it is possible that the United States might prohibit United States investors from complying with what are thought to be the more objectionable features of FIRA.

What is the feasibility of that? What would be the result of that?

Mr. LELAND. In answer, I think we all agree that the investment area has to be dealt with on a multilateral basis in one way, shape or form. We have the GATT for trade, and we may need to establish a whole set of new rules for investment. There are provisions in the GATT that might lead one to conclude that it can take care of the investment issue, particularly the performance requirements, depending on how the FIRA case in the GATT comes out. I think everybody's intention here through the OECD, the Summit, the GATT Ministerial, et cetera, is to develop investment rules.

Otherwise, it will end up being everybody for himself, which will be very damaging. I think it has to be shown multilaterally, that everybody has to be part of the system, the same thing we did with the GATT in the first place. That is a better way of doing it rather than saying we are going to strike at Canada with one particular action or another.

Mr. HORMATS. Can I add to that, because I think that is an important point. Canada is closest to us. We feel, as a result of the close friendship we have with Canada and as a result of the fact that we have a lot of companies that have invested in Canada, we feel a certain concern about Canadian investment policies.

But other countries have done things similar to those practices pursued by Canada, and sometimes they do them less overtly. Sometimes it is with a telephone call that they deny an investment rather than through a FIRA-type of procedure. So, Canada does not stand alone in this process, although as I said before, we look to Canada to set a good example rather than a bad one because of the stature Canada has in the economic international system.

The broader point, though, is that we are really suffering now, "we" collectively in terms of the international economy, from the sort of movement toward more nationalistic intervention in investment decisions than we had a decade ago; this is somewhat akin to the sort of nationalistic intervention in trade policy that you had in the world during the period of the 1930's.

Governments are intervening in other countries as well, including Canada, to require a certain amount of local content to be used in a final product, a certain amount of local engineering, a certain amount of export to come out of a particular project, and this is very disturbing because it can do two things.

One, it can undermine the trading system we have so painstakingly developed over the last couple of decades; and two, it can lead to the sort of friction which we are seeing now but on a broader scale. So unless there are some sort of international rules through the GATT, the OECD or through some other institution, I very much fear that the sort of nationalistic policies that occurred in the 1930's in the trade

area can well develop in the investment area to a greater degree than now and lead to just the sort of problems and friction that characterized the period of the 1930's. That would be serious not just in terms of United States-Canadian bilateral relations but in terms of the overall economic system.

Following that, as in the 1930's, political frictions would emerge. So it is a serious problem, and that is why we have made this a high priority item for both the OECD Ministerial and the GATT Ministerial, and for the Versailles Economic Summit, where we will be making a number of points with respect to overal investment and the global investment climate.

Senator MATHIAS. Suppose this moves along to the point that there is a GATT finding that FIRA is a violation? What do we do then?

Mr. BALE. Mr. Chairman, in recent discussions which Ambassador Brock had with Canadian officials, the Canadians indicated that we both should abide by the GATT decision. Now, what this means is that if it is found that Canada's undertakings in the local content and export requirements are found in contravention of the GATT, then there is an obligation on the part of Canada to remove those undertakings, and these, of course, are the legally enforced undertakings to source purchases by commercial firms locally and/or to export a certain proportion or volume of their output.

So, how does one translate international decisions into international practice? Well, this has to be done in good faith by the member countries of the GATT.

Senator MATHIAS. Now turning to the energy policy for a moment, what effect will the national energy program have on the United States, on our economy, apart from simply the higher price that is undoubtedly going to be paid through American companies? May I take that as a given, that it will result in higher prices?

Mr. HORMATS. It depends on the market. Today we have a buyer's market, so it probably would not at the moment have an impact, but if the market again tightened up, the lack of energy availability would have an effect on the price level, although it is hard to measure because so many other factors would be involved.

We have indicated in the International Energy Agency our concerns over the supply aspect of the NEP.

Senator MATHIAS. Since you mention the glut, is that slowing down development in Canada?

Mr. HORMATS. I do not know the answer to that. We had a meeting at the International Energy Agency in which this was discussed. The general feeling is that a lot of investment seems to have a longer lead-time, but there have been some firms which have pulled out of the Canadian tar sands development. I do not know whether that is the result of short-term price drop or longer-term considerations of the complexity of the project.

Mr. WALDMANN. Even before the present oil situation we saw drilling rigs moving from Canada to the United States. There was some documentation about some 500 of those rigs moving last year, so I don't know if this was triggered by the——

Mr. HORMATS. In part it is the complexity of the project, and in part it may be the price. It is a very complex subject in itself. As of the moment we have not seen a lot of new energy projects being postponed

or canceled because of the drop in price, but there is always that risk.

Our judgment, quite frankly, is that we have twice been caught off guard by big increases in the oil price, and before that having let down our guard and cut down on conservation efforts. No we have to realize that this drop in the price may be only very temporary, and beneficial as it is in the near term to consumers, it should not be seen as something that is permanent.

Prices can shoot up at any time for a number of reasons, and certainly the conservation efforts and the efforts to increase production that have been put into place in the last years should, in our judgment, continue. If we let down our guard again, we could find ourselves in the same situation we were in, in 1973, 1974, and 1978 yet again.

Mr. BALE. Mr. Chairman, on the question of the impact on the United States, I would have some words to say about that, similar to those of Marc Leland. We have followed this closely, and I think if on the trade side we were to look at a few of these things, the impact on investment flows, one impact of the NEP which results from the policy of the Canadians to maintain a low price for feedstocks in Canada, for petrochemical production, is that we are going to face in the 1980's a subsidized export of petrochemical products down to the United States.

The policy in Canada is to maintain a low domestic price to assist the manufacturing of petrochemical products to maintain a competitive position.

Another impact on the investment side—and this is going to have to be assessed as it develops in terms of our trading relationship—that has been noticed—and this is somewhat, at least in the short term, beneficial from our perspective—is there has been a transfer of a number of drilling rigs to the United States from Canada, a rather perverse effect, I would think, from the Canadian point of view because in many instances exploration activity in Canada has stopped, particularly those activities by foreign companies.

Also on the trade side, as Mr. Hormats and Mr. Leland indicated earlier, we are concerned about the impact on major projects of the committee for industrial and regional benefits. There may be, although we have had verbal assurances from the Canadians that there will not be, some trade effect of the implementation of decisions by that committee on the sourcing by major companies on Canadian-owned lands in Canada. But there could be a potential here for a major trade problem as another aspect of the NEP.

These are just a few of some of the impacts, and I am sure my colleagues would like to add to them.

Mr. LELAND. The basic thing you point out, Mr. Chairman, is still there. It is difficult to say how much investment is not going into Canada because of this, although we have all had discussions with people who invest and say even if they usually invest in Canada, they are holding back on it now. And you have this problem when the oil prices are going down, at least temporarily, that is a deterrent to some degree to investment, and we don't want to let our guard down.

Then when in addition you have policies that make it less advantageous for a non-Canadian to invest than a Canadian, and a policy that people are not quite sure where Canadians are going to go next,

once you are on that train, people have other places to put their funds, and people don't put it there and in the end, that costs everybody. It ends up raising the price simply because the supply is less. They are not searching when they ought to be.

Senator MATHIAS. Well, that, Mr. Leland, really leads to some speculation. You say that it will not help Canada and it may have adverse effects for the United States. Again being very careful to point out that this is the Canadians' decision, to which they are entitled, but if it is the independent assessment that there are inefficiencies in these programs, what you are really saying is that the cost of those inefficiencies will be borne by the Canadians but also by the United States, and presumably everyone else whose economies are interlocked with the Canadian economy.

Mr. LELAND. That is true. I think our feeling is, and as I say in my remarks at the beginning, I think the policy is more damaging to Canada than it is to us, but it is damaging to us, too. It is basically a political decision they have made and one which is not universally supported in Canada, while as Bob Hormats points out, we are aware of a certain reluctance, and understandably, by American businessmen not to want to give us case studies because then that only gets them into trouble in Canada. We have no shortage of Canadians who have been telling us they are equally troubled by the policy, and they may be the ones most effective in changing the policy.

Senator MATHIAS. To broaden this discussion just before we close, is reciprocity an appropriate concept to use in assessing the fairness of United States-Canadian economic relations, and if reciprocity is an appropriate concept, are we meeting the test of reciprocity?

Mr. WALDMANN. Mr. Chairman, I address that specifically in a paragraph in my prepared statement. I basically say it is important to draw a distinction between our current concerns with Canada and also the current reciprocity debate, and in our criticisms of the Canadian policies and practices, we have not been subjecting them to a reciprocity standard nor do we imply retaliation in a narrow kind, the way some people interpret reciprocity; rather, we are seeking to have Canada adhere to its existing international obligations and, as we have all said, I think, to a higher standard which we believe is appropriate given the problems we face elsewhere in the world.

Senator MATHIAS. In that connection, let me raise a case, which may not be entirely fair because I believe in some part it results from the recent deregulation of the American trucking industry, and certainly we hope this is a transitory problem, but at the moment it would appear that Canadian trucking firms are having greater access to the United States market than American firms are having to the Canadian market. Should we bite our tongue with patience and hope that this problem will work out, or should we reciprocate in some way?

Mr. HORMATS. This is an issue on which we have held consultations with the Canadians just a few days ago; one of the major issues that was discussed was the question of provincial regulation of trucking. And I must say that we have not had a chance to assess the data in detail or to go over it with our firms, which we fully intend to do, but on the basis of the preliminary assessment, it appears that there is not unfair treatment by the Canadian provincial regulatory authorities.

Now, obviously we have to go over this and examine the data more closely, but I must say the people who went up there and reported to me on this as late as last night indicated that. So we will look into this further, but this was at least their preliminary view, in which case we would not need to take that sort of action.

But on the broader point I would just second what Ray Waldmann said, that we are really looking at this in the context of both the bilateral concerns but also whether Canada adheres to the broader international standards which have been set with respect to investment and with respect to trade. That is why we are discussing the NEP and FIRA in multilateral institutions such as OECD and GATT, because it seems to me where there are multilateral rules and multilateral norms which we and other countries support—and indeed, Canada has also participated in the development of such norms and rules—we ought to use those.

It is far better to hold countries to a multilaterally accepted standard of behavior, one which they generally have accepted as well, than to try to go at these things through particular bilateral remedies, some of which may be ineffective and others may be more harmful to us than they ultimately are to Canada. So we must prefer the multilateral route where possible.

Mr. BALE. Mr. Chairman, may I just amplify on one point? I think Bob has raised an interesting question. The trucking case illustrates the issue, and that is the difference between national treatment and "reciprocity." The Canadians, it appears, as Mr. Hormats has indicated, do not discriminate between domestic and foreign applicants for licenses at the provincial level, but the foreign investor or foreign trucker does run into the problem that he has to apply to the FIRA to gain entry.

That is something where there is a little different condition set, and there is a difference between the two countries in the way they do admit new activities, new businesses. In a broad sense—and I would hope my colleagues would agree with this—the concept of reciprocity is meaningful if it is dealt with in a positive way. That is, one strives for it in its maximum liberal sense.

That reciprocity has been a principle since 1934 in our tariff acts, and it has meant that we should achieve trade liberalization in a reciprocal manner, and I think that is our objective, both national treatment for investors and trade, and of course in the GATT you have enshrined in article III on the trade side the nondiscrimination between imports and domestic goods, and what you would like to do is broaden that to the investment area and in a bilateral sense and in a multilateral sense achieve a broad, reciprocal free movement of goods and capital.

Mr. HORMATS. Let me just add something on the trucking point so there is no misunderstanding. The point I thought you raised was that ability of American truckers to go in and out of Canadian provinces. There is a second question, and that is the right of establishment of an American trucking company in Canada.

That is another issue, and on that there is the need to go through FIRA in order to establish in Canada, and there Harvey is quite right, there is a difference between the way Canadian and American truck-

ing firms are treated. In Canada the FIRA process is inherently discriminatory in that it subjects foreign investment to a screening process and sets of conditions potentially that a Canadian firm doesn't have to face. In that one there was a difference.

Senator MATHIAS. Not only is there a difference but it is my impression that the difference isg rowing, because under the deregulation it is easier for Canadians, and under FIRA it is harder for Americans.

Mr. WALDMANN. I do not think the administration has yet taken a position on the operating question, but it will be somewhat colored by the consultations which are going on with the Canadians now.

Mr. HORMATS. That comes to the overall question of FIRA again, and there you do have an inherent discriminatory process.

Senator MATHIAS. Let me ask you one last question, and a rather practical one for the members of the Foreign Relations Committee because we have pending in this committee and in the Senate at large, several treaties, several bills, that concern different aspects of United States-Canadian economic relations.

Is the administration prepared to take a comprehensive view of all of these pending proposals and to give the Congress its advice as to how they should be dealt with?

Mr. LELAND. Mr. Chairman, to add a bad pun, I agree with my colleagues that it would be a mistake to have no truck with the Canadians. I think we have a lot of relations with them, and we have independent relationships that have to be considered. For example, one of the treaties we have is the tax treaty which is presently being considered, and there are some elements which are now being renegotiated primarily because of the timing of the treaty and the change in our real estate capital gas taxation.

But basically when you do arrange bilateral treaties——

Senator MATHIAS. For an equally bad pun, that is on a different plane. [Laughter.]

Mr. LELAND. Maybe I should not have started. But basically, in a treaty we should be getting as much out of it as we are giving, and when we do negotiate our tax treaties, we feel we do. So often the fact of somebody trying to use something else away when we have to make sure in what direction the weapon is pointed, but I do think what developed from this hearing and from what everyone is saying, is that we do have a lot of things we can do regarding the Canadians. But it does not mean simply that we would close off or try to stop all the other things that are going through in order to try to achieve objectives that are going to be difficult to achieve but I think with certain pressures we can achieve.

Mr. WALDMANN. Mr. Chairman, the Trade Policy Committee and the Cabinet Council on Commerce and Trade have both considered and are considering as an ongoing matter the total relationship on this economic and commercial question, which does involve some of the treaties that are pending before the Senate now. To the extent that, as Marc says, specific items stand on their own and can be dealt with on their own feet, then that would be considered in that context.

But we are concerned also that we not send the wrong signal to the Canadians that we are not concerned about these elements of the trading and investing relationship which may in fact color or infect other policies of the administration.

Senator MATHIAS. Is there anything further that any of you would like to add? It has been a very educational morning for me and I appreciate the fact that each of you would be here and be as forthcoming as you have. It seems to me that the kind of concern that you have expressed and the depth of your knowledge of this subject, the attention you have obviously been paying to it is just a measure of our interest in United States-Canadian relationships, not only our desire but our commitment to not letting them deteriorate, to maintaining them at the highest level of mutual benefit for both countries.

I think that came across to me, and I hope it came across to others in the room and to still others who will read this transcript, because that is the message. It is a desire to improve the relationship and not in any sense to allow it to deteriorate.

Thank you very much.

The committee will stand adjourned.

[Whereupon, at 11:43 a.m., the subcommittee adjourned, subject to call of the Chair.]

# APPENDIX

## PREPARED STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC., NEW YORK, N.Y.

The National Foreign Trade Council, a private, nonprofit organization of some 650 companies engaged in foreign trade and investment, welcomes the opportunity to propose recommendations regarding current U.S.-Canadian economic relations. Our member companies—which account for a very large proportion of U.S. investment in and trade with Canada—have become increasingly concerned about the adverse impact of economic nationalism in Canada on the international investment and trading system and its particular effect on U.S.-Canadian relations. We urge the U.S. Government to take the necessary steps to convince our largest trading partner that its current Canadianization policies threaten to invite reciprocal discriminatory reactions in the United States and elsewhere, invite protectionism among industrialized countries and thus prove self-defeating for Canada in the long run. In our judgment, all nations stand to lose if restrictive international economic policies are adopted; all will gain by the preservation of a world economy open to the free flow of trade and investment.

Four recent developments are of particular concern as being inconsistent with international principles of nondiscrimination, a free and open investment and trading system and also as being inconsistent with the traditional neighborly U.S.-Canadian economic, security and cultural relations to which our two peoples have long since become accustomed.

### 1. THE ROLE OF CANADA'S FOREIGN INVESTMENT REVIEW AGENCY (FIRA)

Established by the Foreign Investment Review Act of 1973 to screen foreign investments FIRA has wide review and approval powers which provide the Canadian Government a direct discretionary tool to control, channel and exclude foreign investment activity as it sees fit. FIRA's procedures leave foreign investors uncertain as to which investments will or will not be approved. Among the discriminatory aspects of FIRA's policies are performance requirements imposed on foreign firms seeking to invest in Canada including obligations to purchase Canadian goods and services (such as data processing and financial services), and to reduce imports and to export specified percentages of production.

### 2. THE CANADIAN OIL AND GAS ACT

(An element of the National Energy Program, which among other objective aims to increase Canadian ownership of the petroleum industry to at least 50 percent). The Act gives the federal government the right to take retroactively a 25 percent interest in oil and gas properties being developed by companies on Canada lands leased from the federal government. This so-called "back-in" feature provides that, on successful exploration ventures on Canada lands, the leaseholder will be reimbursed for its actual expenses for this 25 percent interest in the successful areas alone, and this reimbursement will be provided from the government's share of future petroleum production from the area taken. Such reimbursement fails to meet the international law standard of prompt, adequate and effective compensation for an expropriation.

The same act has the effect of requiring 50 percent Canadian ownership as a condition for issuance of production licenses for Canada lands. This provision severely limits the number of consortia available for foreign petroleum company participation while expanding consortia participation activities for Canadian owned firms.

Shortly to be taken up by Parliament, the petroleum incentive features of the National Energy Program will make available subsidies ranging up to 80 percent of exploration and development expenditures to Canadian firms depending on the degree of Canadian ownership with 50 percent being required for receipt of the minimum subsidy. Companies 50 percent or more owned by foreign interests are not entitled to receive incentive payments. General tax provisions providing incentives available to oil and gas explorers and producers on a nondiscriminatory basis will be abolished.

### 3. COMMITTEE ON INDUSTRIAL AND REGIONAL BENEFITS (CIRB) ESTABLISHED IN 1981

Concern has been expressed that this Committee may be designed so as to favor Canadian suppliers in bidding on major government projects.

### 4. BANKING REGULATIONS

Although the Canadian Bank Act of 1980 provides investment opportunities for foreign banks, nonetheless that Act has discriminatory features against foreign banks. Thus, the Act imposes a ceiling which limits total foreign banks' market share (to 8 percent of total domestic bank assets), prohibits certain activities and provides for annual licensing. Canada also forbids the acquisition of controlling interests in domestic banks by foreign firms as well as prohibiting foreign banks to do business in Canada through branches.

By adopting such policies as the foregoing, Canada may well be departing from the national treatment principles set forth in the General Agreement on Tariffs and Trade and also from the international rules of nondiscrimination toward foreign investment endorsed by Canada and other member countries of the Organization for Economic Cooperation and Development in the 1976 decision of the OECD Council on National Treatment. Moreover, certain aspects of the National Energy Program raise questions as to their validity under rules of general international law.

The broad principle of national treatment of foreign investors is of concern to large parts of the American business community with multinational operations. including computer, telecommunications and office equipment manufacturers, publishers and broadcasting media. Not only are their investments in Canada potentially at stake, but also the Canadian example may encourage other governments to follow similar restrictive policies.

While it would not serve larger interests to take hasty retaliatory actions which might lead to further restrictions on the investment of U.S. companies having a secure stake in Canada and enjoying good relations across the border, Canada should understand, however, that the long-term relationship must be grounded in fair treatment on both sides. In a spirit of mutual cooperation. U.S. measures designed to promote that relationship should be designed so as not to raise the level of counter-retaliation, which could make bad matters worse.

### RECOMMENDATIONS

Thus in an effort to improve the economic climate between the United States and Canada, the Council suggests:

1. An intensification of bilateral diplomatic representations at all levels of government to seek amendment of discriminatory Canadian legislation and other measures including the Canada petroleum lands "back-in" without just compensation. It is fair to note, however, that diplomatic representations by the U.S. Government so far have had only limited effect on Canadian actions.

2. Stronger representations in multilateral forums including the coming economic summit at Versailles and in the Organization for Economic Cooperation and Development at the ministerial level to urge Canadian adherence to the 1976 OECD Decision on National Treatment.

3. Vigorous efforts should be made to pursue U.S. complaints under the GATT. Formal consultations with Canada under Article XXII could lead possibly to authorization under Article XXII to suspend tariff concessions to Canada.

4. Although multilateral solutions are to be preferred, the U.S. Government may want, in addition, to consider as a possible alternative the application of Section 301 proceedings under the Trade Act of 1974 as amended, which grants flexible authority to the President to prescribe tariffs and quotas or to take other

measures in response to discriminatory actions by foreign governments which impose an "undue burden" on U.S. commerce. It should, however, be appreciated that application of such sanctions can lead to a buildup of international retaliation and is therefore not recommended in ordinary circumstances.

5. The United States should consider seeking international arbitration or the institution of proceedings before the International Court of Justice charging violation by Canada of the rules of international law governing expropriation and the payment of prompt, adequate and effective compensation.

6. Nondiscrimination with respect to trade and investment should be the hallmark of treaties relating to economic relations between the United States and foreign countries. Thus, the tax treaty pending between Canada and the United States should be reviewed from this perspective by the Senate as it considers whether to give its advice and consent.

7. Looking to the future, consideration should be given to the establishment of an OECD investment program providing multilateral protection against the risk of loss due to violations of the standards prescribed by the OECD Declaration on Investment.

The Council is not recommending legislation aimed specifically at retaliation against Canada. It should, however, be emphasized to Canada that Congressional concern is mounting. Thus sentiment is growing for hearings under the Mineral Lands Leasing Act of 1920 to determine whether Canada is providing reciprocal treatment to U.S. mineral leases on Canada Lands.

Every effort should be continued at the diplomatic level and in multilateral negotiations for Canada to live up to its international obligations and to understand the risks of retaliatory actions that could be generated by its present policies and attitudes. These policies increasingly endanger the free flow of trade and capital and the open international trade and investment system which has characterized international economic relations for more than three decades.

# THE ROYAL BANK OF CANADA

## BANKING RELATIONS BETWEEN THE UNITED STATES AND CANADA: NATIONAL TREATMENT IS WORKING ON BOTH SIDES OF THE BORDER

## EXECUTIVE SUMMARY

This material is circulated by Prather Seeger Doolittle & Farmer, 1101 Sixteenth Street, N.W., Washington, D.C., a law firm registered under the Foreign Agents Registration Act of 1938, as amended, as an agent for The Royal Bank of Canada, Montreal, Canada. Copies of this material are filed with the Department of Justice, where the required registration statement is available for public inspection. Registration does not indicate approval of the content of this material by the United States Government.

October 15, 1981

## INTRODUCTION

The United States and Canada are currently at a difficult point in their economic relations. Canada's proposed National Energy Policy and the actions of its Foreign Investment Review Agency have stirred cries of discrimination in the U.S. business community and, in some cases, prompted calls for retaliation against Canadian interests in the U.S. With the Administration now reviewing its policies toward Canada, there is thus a great deal of uncertainty over future U.S. treatment of Canadian investment.

This paper does not attempt to address the larger foreign investment and energy issues that have precipitated a U.S. policy review. Its purpose instead is to show that, whatever the merits of the disputes in those areas, they should not be allowed to affect the national treatment policies which each country has recently worked so hard to achieve in the banking area.

Despite very different banking systems, the U.S. and Canada have developed remarkably similar policies of national treatment toward foreign bank operations. Each country developed its policy in response to a rapid growth of foreign bank operations that occurred during the 1970s. This growth is analyzed and compared in the first part of

this paper, with particular reference to the growth of Canadian banks in the U.S. and U.S. banks in Canada. In general, U.S. banks have led foreign bank growth in Canada, while over the past decade Canadian banks in the U.S. have grown at a slower rate than the U.S. foreign banking community as a whole.

The paper then compares the background and provisions of the U.S. International Banking Act of 1978 and the Canadian Banks and Banking Law Revision Act, 1980. It is evident from this review that the U.S. and Canada have each been guided in their legislation by a pragmatic approach to national treatment that has sought to accommodate a number of competing private and public sector policy interests. This approach in each country has resulted in widely-accepted legislation that extends a basic equality of treatment to foreign banks and affords them a stable, regularized place within the domestic banking structure. In banking relations, national treatment is accepted and working on both sides of the border and should remain unaffected by disputes in other areas.

## I. A STATISTICAL COMPARISON OF CANADIAN BANKS IN THE U.S. AND U.S. BANKS IN CANADA.

### A. Canadian Banks In The U.S.

A number of salient facts emerge from the statistics concerning Canadian and other foreign banks in the U.S.

First, Canadian banks have a very small presence in the U.S. market. For example, they have less than 1 percent of total U.S. banking assets.

Second, over the past decade, the rate of expansion of Canadian banks in the U.S. has been significantly below that of foreign banks as a whole.

Third, Canadian banks have an important but by no means dominant presence in the U.S. foreign bank community. In the 1970s, their share of total foreign bank assets in the U.S. actually declined.

B. U.S. Banks In Canada

Again, a number of salient facts emerge from the statistics.

First, U.S. banks have a dominant position among foreign banks in Canada. They have a 57 percent share of foreign bank domestic assets. This contrasts sharply with Canadian banks' 7.9 percent share of foreign bank banking assets in the U.S.

Second, as with Canadian banks in the U.S., U.S. banks have focused on the business loan market in Canada. Their estimated 6 percent share of that market in Canada is more than twice Canadian banks' 2.3 percent share of the business loan market in the U.S.

Thus, U.S. banks have managed to establish a relatively more significant presence in Canada than Canadian

banks have in the U.S. There is no evidence that U.S. banks have suffered from any special discrimination in entering Canada. If anything, their geographic proximity and familiarity with Canadian business customers and with U.S. affiliates of Canadian firms have given them a significant inherent advantage over other foreign banks entering the Canadian market.

C. Cross-Border Lending By U.S. And Canadian Banks

Looking at cross-border lending to nonbank customers, it seems clear that a preponderance of such loans have flowed from U.S. bank offices to Canadian residents. For example, for the years 1977-1981, total cross-border claims of large U.S. banks on nonbank Canadian residents averaged approximately $2.3 billion. In contrast, total claims on nonbank U.S. residents held by banks in Canada for the same period averaged only $340 million.

## II. A COMPARISON OF THE U.S. INTERNATIONAL BANKING ACT OF 1978 AND THE CANADIAN BANK ACT OF 1980.

Foreign banks in both the U.S. and Canada had certain regulatory advantages and disadvantages vis-a-vis domestic banks prior to the passage of the International Banking Act of 1978 (IBA) and the Banks and Banking Law Revision Act, 1980 (Bank Act). The IBA and Bank Act have eliminated these basic disparities by integrating foreign banks into the prevailing domestic regulatory structures.

Because the U.S. and Canadian banking systems are, in turn, very different in their basic structures (over 14,000 banks in the U.S. versus 11 domestic banks in Canada), it is misleading to try and compare what Canadian banks can do in the U.S. with what U.S. banks can do in Canada. Consistent with national treatment, the real question is whether, within each country's banking system, foreign banks are being discriminated against vis-a-vis domestic banks. From a brief review of the IBA and Bank Act, it is clear that a basic and fundamentally similar system of equality of treatment now prevails in each country.

A. Treatment Of Foreign Banks In The U.S.

Largely following a national treatment approach recommended by the Treasury and Federal Reserve, the IBA terminated, or at least restricted, five principal advantages foreign banks were deemed to enjoy over domestic banks in the U.S., and also removed several disadvantages which had previously existed. Under the IBA, Federal Reserve reserve requirements were made mandatory for all branches and agencies of foreign banks with worldwide assets in excess of $1 billion; deposit insurance was required for branches accepting retail deposits; except for grandfathered offices, foreign banks were prohibited from accepting domestic deposits at branches located outside a designated home

State; and, again except for certain grandfathered operations, foreign banks with branches and agencies were made subject to the prohibitions of the Glass-Steagall and Bank Holding Company Acts. The IBA also gave foreign banks the option of establishing Federal branches and agencies, of acquiring controlling interests in Edge Act Corporations, and of having some non-U.S. citizen directors at a national bank subsidiary.

Overall, the IBA's approach to national treatment was a pragmatic one. Foreign banks were given special exemptions in certain areas, such as nonbanking activities, to avoid extraterritorial problems and unnecessary regulation. At the same time, foreign banks were subjected to special burdens, such as Federal Reserve reserve requirements for national monetary policy reasons, even though such requirements were not then mandatory for all banks in the U.S.

B. Treatment Of Foreign Banks In Canada

1. Like the IBA, the Bank Act is based on national treatment.

Prior to the Bank Act, foreign banks were prohibited from establishing bank subsidiaries in Canada. Nevertheless, they rapidly penetrated the Canadian market through various forms of nonbank financial affiliates. In its 1976 White Paper, the Canadian Government identified a number of

important competitive advantages which these nonbank financial affiliates had over chartered banks in Canada: (i) they were exempt from reserve requirements; (ii) they could provide certain financial services that Canadian banks could not provide directly; (iii) they were not subject to any of the regulatory or supervisory provisions of the Bank Act; (iv) they may have had some advantages over smaller Canadian banks and borrowers in raising funds in the Canadian money market; and (v) they were generally outside the direct scope of central bank influence. However, the Canadian Government indicated that foreign banks also operated under substantial disadvantages since the lack of a bank charter prevented foreign banks from providing Canadian customers the complete range of domestic and international banking services that could be provided by Canadian banks.

The basic solution proposed in the White Paper was to eliminate the major disparities of treatment by enabling foreign banks to obtain a Canadian bank charter, thus fully integrating them into the domestic regulatory structure.

In recommending this legislative solution, the Canadian Government clearly recognized the benefits to be afforded from foreign bank participation in Canada:

> Foreign banks are to be encouraged because of the additional competitive and innovative forces that they can bring to bear in the relatively highly concentrated Canadian banking system. They are to be encouraged too because of the additional financial support which they, with their world-wide connections, can bring to the development of our resources, industries and trade.

Consistent with the recommendations of the White Paper, the recently enacted Bank Act greatly encourages foreign bank entry by giving foreign banks the opportunity to obtain banking charters. Foreign bank subsidiaries in Canada are granted all the powers afforded other chartered banks, including the ability to accept deposits from the public. They also must bear all the responsibilities of chartered banks, including the requirement to hold reserves.

Since enactment, it is estimated that approximately 52 foreign banks have applied for charters, eighteen, or one-third of them, from the U.S. Of the first twelve charters issued, four, or one-third, went to U.S. banks.

2. Limitations or restrictions in the Bank Act on foreign bank subsidiaries are reasonable and consistent with national treatment.

While foreign banks have embraced the opportunity to establish foreign bank subsidiaries, some U.S. and other foreign banks have from time to time expressed either private or public dissatisfaction with certain limitations or restrictions contained in the Bank Act.

Leveraging and Branching Requirements

In conformity with longstanding domestic policy, the Bank Act requires shares of Schedule A banks to be widely-held. Foreign bank subsidiaries and other Canadian banks not meeting this requirement must be chartered as Schedule B banks. Schedule B banks may not exceed a 20 to 1 leverage ratio and need prior approval to open more than one Canadian branch.

While it is expected that most Schedule B banks will be foreign bank subsidiaries, the leveraging and branching requirements are non-discriminatory, as they apply to all Schedule B banks, whether Canadian or foreign-controlled. In this regard, the leveraging requirements put foreign bank subsidiaries on an equal competitive footing with other new domestic Canadian banks that may be chartered under Schedule B. U.S. authorities follow a similar principle of requiring smaller U.S. subsidiary banks of foreign banks to meet the more conservative capital standards of their U.S. bank peer group, irrespective of the parent foreign bank's size.

The leveraging requirement also ensures equality among foreign banks, i.e. all foreign banks will be subject to the same rules irrespective of their home country standards.

Finally, with respect to the branching requirements, they will have little or no competitive impact on wholesale banking operations, the chief thrust of U.S. bank operations in Canada. Moreover, foreign banks applying to convert nonbank affiliates into Schedule B banks, may apply to retain their existing nonbank offices as bank branches. For example, one U.S. bank already has received permission to convert some 28 finance company offices into branches of its Canadian bank subsidiary.

Data Processing Requirement

The Bank Act requires all Schedule A and B banks to maintain and process in Canada any data or information relating to the preparation and maintenance of bank customer transaction records. The purpose of this requirement is to ensure that the Inspector General of Banks will at all times have access to information in Canada that will enable him to carry out his supervisory responsibilities for all chartered banks. Provisions allowing banks, on advice to the Inspector General, to make copies or take extracts from customer records in Canada and further process information or data relating to such copies outside Canada ensure that U.S. and other foreign banks are not denied access to information that may be crucial to overall management or banking functions.

While non-discriminatory, the requirement has nevertheless raised questions about Canada's possible approach to the broader subject of transborder data flows. It must first be stressed that, as discussed above, the requirement is intended to meet certain unique Government supervisory responsibilities in the banking sphere, and is thus limited to that industry. Second, it must also be stressed that the Canadian Government has not yet developed a final position on questions raised by transborder data flows, which questions are currently being studied by an Interdepartmental Task Force.

The Eight Percent Ceiling

The Bank Act provision which has sparked the most concern among U.S. banks in Canada is the eight percent ceiling, i.e. foreign bank assets cannot exceed eight percent of the domestic assets of all banks in Canada. Before addressing objections to the ceiling, it is important to recognize that because of differences in national banking systems, economic histories, and policy priorities, and the resulting great diversity of structure and operations among the world's large banks, national treatment can at best be expected to impose a rough parity of treatment between domestic and foreign banks within a country. Thus, the effectiveness and equity of a legislative scheme

designed to bring about national treatment must be judged on pragmatic grounds. This was the U.S. experience in developing the IBA, where competing U.S. policy interests resulted in both special exemptions and special burdens for foreign banks. A similar approach has prevailed in Canada where, in light of its small number of banks and a great number of unknowns concerning the first time permission for foreign bank entry, the Government has attempted to achieve a pragmatic balance among its three aims of (a) maintaining control of the banking system in Canadian hands, (b) preserving competitive opportunities for smaller Canadian banks and (c) encouraging foreign bank entry and competition.

It is particularly important to recognize three facts concerning the history of the ceiling: (i) it was conceived as part of the 1976 White Paper, a Government attempt to encourage, not prevent, foreign bank entry; (ii) it was, in fact, opposed by many Canadian banks who welcomed even freer foreign bank competition and entry; and (iii) the ceiling itself was actually liberalized somewhat during consideration of the Bank Act, and a proposed $500 million (Can.) ceiling for individual foreign bank subsidiaries was eliminated. This elimination of an individual bank ceiling was a particular benefit for U.S. banks with their larger base of existing Canadian operations.

Concentrating on the principal objections that have been raised to the ceiling, it is first of all premature to suggest that the ceiling will unfairly restrain foreign bank growth or competition in Canada prior to the next decennial revision of the Bank Act in 1991.

Because the ceiling is based on total banking assets in Canada, and because foreign banks are presently well below the ceiling, the ceiling will actually permit foreign banks to grow in the aggregate at a faster rate than that of the Canadian banking system as a whole. For example, if total Canadian banking assets increase by 100 percent in 1991 to $444 billion (Can.), foreign bank assets, now estimated at $10.4 billion (Can.), could actually grow at a rate of more than 300 percent to $35.5 billion (Can.), and still be within the eight percent ceiling. In addition, the total domestic asset figure is a large and expanding base which allows for substantial future growth. For example, during the five-month period from February 28, 1981, to July 31, 1981, the eight percent ceiling amount increased from $15.6 billion (Can.) to $17.8 billion (Can.), an annualized rate of increase of 34 percent. At this projected rate of increase, the eight percent ceiling would be $19.2 billion (Can.) at the end of October 1981.

Second, the ceiling allows for a significant aggregate market share increase, since foreign banks' current

market share of 4.8 percent is only sixty percent of the eight percent market share permitted by the Bank Act.

Third, U.S. and other foreign banks' share of the wholesale banking market, especially in key Canadian banking centers, is likely to be far in excess of the overall eight percent market share allowed by the Bank Act. For example, foreign banks currently have seventy-five percent of their total assets in Canadian business loans. Applying this ratio to a June 30, 1981 ceiling of $17.3 billion (Can.), foreign banks could actually increase their total amount of business loans to $13 billion (Can.), which would represent 17.6 percent of the total business loan market in Canada as of June 30, 1981, a share almost equal to foreign banks 18.9 percent share of the business loan market in the U.S. Since applications filed to date indicate that foreign banks are further concentrating their wholesale banking activities in a few major cities, their share of the wholesale banking market in these areas will likely be in excess of their share of the national business loan market. This has clearly been the case in the U.S. where foreign banks' share of the business loan market in New York, for example, is more than twice their share of the business loan market in the U.S. as a whole. Thus, foreign banks' share of the business loan market in major Canadian banking centers could be several times the eight percent national market share allowed by the Bank Act.

Fourth, the ceiling has no effect on cross-border loans from U.S. banks to Canadian residents, an important source of U.S. banking competition. For example, in 1980, U.S. banks made cross-border loans and commitments to Canadian residents and guarantors almost equal to the amount of assets they now hold in Canada. Thus, U.S. banks' penetration of the wholesale banking market in Canada will, in fact, be far in excess of the amount of assets held by their Canadian bank subsidiaries.

Fifth, U.S. banks have expressed concern that given their dominant position and a likely number of additional foreign bank entrants, their subsidiaries might be subject to severe individual restrictions on their future growth, e.g. be given a relatively low amount of deemed capital under the 20:1 leverage ratio. However, the U.S. has already received assurances from Finance Minister MacEachen that U.S. banks would not be treated in a discriminatory manner. Moreover, it appears from the first round of charters approved that foreign banks with existing operations in Canada are being given substantially larger deemed authorized capital figures than foreign banks new to the Canadian market. This should particularly benefit U.S. banks with their large existing base of operations in Canada and, in fact, will likely preserve their strong position in the Canadian market. For example,

while U.S. banks received one-third of the first twelve foreign bank charters, their subsidiaries were given 56 percent of the deemed authorized capital of those first twelve banks, a percentage almost identical to their current 57 percent share of the foreign bank market in Canada.

Lastly, the ceiling is a reasonable attempt by Canada to deal with a substantial number of "unknowns" concerning foreign bank entry. The Bank Act is Canada's first real attempt to hold itself out as an international banking center and attract foreign banks. In contrast, the U.S. has long been one of the world's leading international banking centers with a well-established foreign bank community. Thus, for Canada, first time permission for foreign bank entry has posed a number of fundamental questions concerning the control of its economy and the structure and soundness of its banking system. Would smaller Canadian banks still be able to compete? Would a sudden influx of the world's largest banks cause a rapid and perhaps unnecessary rise in credit expansion? Would control over the banking system shift rapidly into foreign hands? Would new supervisory procedures be needed to deal with perhaps a fivefold or more increase in the number of banks? Because these questions could not be answered with any certainty, and because the important issues raised would be virtually impossible to deal with on a retroactive basis, a ceiling

was adopted to ensure that foreign bank entry and expansion would be in a gradual and orderly manner that would result in the secure establishment of foreign bank operations within the domestic banking structure.

3. Foreign bank applications are not subject to FIRA.

Since Canada's Foreign Investment Review Agency (FIRA) has stirred much criticism from among U.S. investors, it is important to recognize that the Foreign Investment Review Act will not apply to any proposal to establish or acquire control of a foreign bank subsidiary. Any such proposals will be governed solely by the Bank Act, and charters will be issued by the Minister of Finance on the approval of the Governor in Council, without any approval being required from FIRA. In this regard, the Minister of Finance is required to make only two basic determinations concerning a foreign bank subsidiary: (1) reciprocity; and (2) a potential contribution to competitive banking in Canada. U.S. banks have had no problems in meeting these requirements.

## CONCLUSION

Both the U.S. and Canada have adopted legislation which is based on the principle of national treatment toward foreign bank operations. While competing policies and priorities have led each country to make certain pragmatic judgments as to what constitutes effective national treatment for foreign banks, it is nevertheless clear that foreign

banks in each country now have the same basic privileges and responsibilities as domestic banks. These national treatment policies should be given a reasonable chance to work and, as between the U.S. and Canada, should not be affected by disputes in other areas. Linkage of banking to other economic or trade problems would be especially unwise since it would create great uncertainty in the international banking system which depends heavily on the confidence of banks, borrowers, depositors and investors in the stability of banking operations and relationships.

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